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CONTENTS

DEPARTMENTS

Accounting News And Trends

COMPETITIVE BIDDING

A Case Study of a competitive bidding situation involving a California city, prepared by a special Coordinating Committee on Competitive Bidding of the California Society of CPAs, is presented in *The California CPA Quarterly* (September 1960). The study consists of these documents: (1) the city's notice calling for proposals, including a statement of the general requirements of the audit, and (2) letters of reply from six CPA firms; and the conclusions of the majority members of the Committee as to possible violations of Rule 17 which prohibits competitive bidding.

Included in the material issued by the city was a requirement that a specific fee schedule accompany the accountant's proposal. The letters written by the six firms could be grouped into three categories:

1. Those refusing to mention price at all (two in number).

2. Those quoting hourly or per diem rates but refusing an estimate of maximum or total fee (three in number).

3. One firm which gave an estimate of total fee but inserted this paragraph:

"In connection with the foregoing estimates, it is requested that they are not to be used in any way to influence the selection of auditors in the event other accounting firms have submitted proposals."

In four of the replies specific attention was called to the Rules of Professional Conduct prohibiting competitive bidding, and two replies cited an opinion of the Attorney General that cities are not required to engage public accountants through this device.

The Committee's conclusions were:

Group 1—These letters complied with Rule 17.

Group 2—The writers recognized that a potential competitive price situation existed and they believed that a maximum fee could not be quoted. The presentation of hourly or per diem rates, however, afforded the basis for price comparison and such a practice violates Rule 17.

Group 3—This was clearly a violation and the inclusion of the quoted paragraph does not relieve the writer of his responsibility to assure himself that a competitive price bidding situation does not exist.

NEW CONCEPTS IN MANAGEMENT OF AN ACCOUNTING PRACTICE

An address by Gordon Ford to the 1960 meeting of the Florida Institute of CPAs entitled "New Concepts in Management of an Accounting Practice" is now being circulated in printed form by the Florida Institute. The talk covers all aspects of managing an accounting practice but the comments on billing and on staff selection might be especially helpful to the smaller CPA firms. With respect to billings:

Accounting News and Trends is conducted by CHARLES L. SAVAGE, CPA. He is presently serving as a member of our Society's Committee on Accounting Procedure and is Program Director of the Brooklyn Chapter of the National Association of Accountants. Dr. Savage is professor of accounting and chairman of the Business Administration Division of St. Francis College. He is also professor of taxation at the New York Law School.

1. The keeping of good records, particularly good time records is a very important part of collecting satisfactory fees. These records usually show more time spent on engagements than does an educated guess.

2. Separate bills should normally be sent for special services. Thus one bill would go out for the regular audit followed by other bills for budgeting, tax planning, revenue agent's examination, etc.

3. One-time engagements should not be billed at regular rates. These should command a premium and any other course is unfair to regular clients.

4. Experience shows that someone in addition to the partner in charge of the account should be consulted when the bill is prepared. There appears to be a natural impulse to suggest the same bill as last year even though the work would support a higher amount.

5. Rates should not be reduced during slack seasons. This only cuts fees and standards and it is usually impossible to get on the correct fee basis with this particular client.

In discussing selection of personnel, Mr. Ford offers this personal observation:

"One of the greatest problems in staff selection (and the smaller the firm the greater the probability) is that men are employed because they happen to be needed at the particular moment. The time for you to make an addition to your staff is when the right man is available. I know this may sound like nonsense, but experience is a dear teacher, and what I have just said has cost us a lot of money to learn. Let me repeat: If your outlook is that sometime within the coming year you plan an addition to your staff, don't wait until you are swamped with work and your judgment is altered immeasurably by such

pressure. Start looking for the recruit right now, and while there is no pressure, begin interviewing, testing and investigating many in making your selection."

SMALL BUSINESS BANK LOANS

CPAs will find of interest some comments concerning small business term loans made by Rudolph A. Biborsch in his article cryptically entitled "Mechanical Considerations" (*Robert Morris Associates Bulletin,* April 1960).

A specially developed application for these types of loans requests information about the business itself as well as about its principals. Some of the items covered in addition to a statement of assets and liabilities and operating figures are: a record of all insurance carried, a complete schedule of equipment owned and any indebtedness in connection therewith, and a schedule of real estate holdings with information covering the balance of mortgage as well as the exact name in which title to these properties is recorded. The author points out that one of the most difficult problems in a small business loan program is to obtain financial statements that represent even an approximately true picture. Since most small businesses do not employ qualified public accountants, the figures reported are round figures and sometimes are either the individual's guess or represent what he wishes to disclose.

The rates and repayment schedules for these loans are in general as follows: loans from \$500 to \$3,500 the rate is 6% discounted and the terms 12 to 24 months; on loans \$3,501 to \$10,000 the rate is 6% simple interest on the portion above \$3,500 and terms go up to 36 months; on loans over \$10,000 the rate is 6% simple where practicable but may be lower

where individual situations warrant a preferred rate. This type of loan in general warrants a rate at least .5% higher than for unsecured temporary credit.

Among the provisions of the loan agreement are warranties and covenants covering such items as: supplying the bank with financial information periodically; permitting the bank's representatives to audit the books of the term loan borrower; requiring bank's consent to pay dividends; stipulating that borrower will not incur other indebtedness for borrowed money, or lend money; in addition reference is made to maintaining personnel satisfactory to the bank and to having an adequate insurance program.

REPORTING FINANCIAL INFORMATION TO EMPLOYEES

A subject not often written about in professional literature in the United States is discussed in "Reporting Financial Information to Employees" by R. Keith Yorston in *The Australian Accountant* (February 1960). The author surveyed current practices in this field and, since 58 percent of the companies responded to his questionnaire, concluded that many companies are interested in the problem. The main difficulty in conveying financial information to employees is that there is no uniformily understood objective as to what employees' reports should achieve, what the employees want to know, or how to get the message across to them.

In Australia it appears that most companies are making little effort to inform all employees but nearly one-half supply financial information to executives and senior employees. Many firms which have prepared special reports for employees, usually in simplified form, have abandoned them, either because of employee suspicion that they are different from the correct reports or because of employee resentment of being "talked down to."

Some of the items that the author believes should be included in reports to employees are:

1. Income statements and balance sheets as presented to stockholders.
2. Thanks and tribute to employees for special achievements.
3. Total payments to employees and other employee statistics. Show employees what share of revenue they are getting compared with shareholders, taxation, and other interests.
4. Description of company's future plans and prospects—certainly this is as interesting to an employee as a stockholder.
5. Information about the stockholders. Employees are interested in knowing where they live, what are their occupations—are they bankers, stockbrokers, investors or just ordinary people like themselves?
6. Information about the product or service the employee has helped produce. He is interested in such things as its value and importance and the part it plays in the life of the community or the nation.

Letters to the Editor

ECONOMICS OF CPA PRACTICE—A COMPARISON WITH OTHER PROFESSIONS

A profession is an occupation in which the practitioner exchanges his time, knowledge, ability, experience, education and skills for monetary return. The professional man enjoys the respect and consideration of his fellow man. This creates a great deal of satisfaction but does not discharge the economic burdens and obligations of day-to-day living. He should have an income from professional practice in sufficient amount to discharge the financial burdens of rendering good professional services and to enable him to be a useful and respected citizen, and to care for his family needs.

During the 1930s surveys conducted by the U. S. Department of Commerce indicated that on a national basis, the practicing CPA led the other professions in net income. Although the dollar difference was small, the professional practitioners at that time ranked as follows: (1) CPAs, (2) lawyers, (3) physicians, and (4) dentists. Since then, physicians and dentists have increased their earnings so that they now hold the first and second positions. The mean average increase of the more experienced CPA practitioner and partners can only be estimated from the recent Institute bulletin (in the series, "Economics of Accounting Practice") and appears to be slightly higher than the dentist average. This would indicate that the mean average income of all practicing CPAs falls somewhere between that of the lawyers and the dentists, in number three position.

The conclusion is that the incomes of CPAs have not been increasing at the rate comparable to other professions during the past twenty years. Apart from the steps that CPAs can take individually in evaluating the "economics" of their practices, it would be interesting to speculate as to the profession-wide factors which account for this relative decline and the larger steps which can be taken to reverse the trend.

MILTON E. MANDEL, CPA
Jersey City, N. J.

"UPDATING" ARTICLE ON OIL DEPLETION

As the August 1960 issue was going to press, two events occurred which affect my comments contained in the article "Depletion in the Oil and Gas Industry" with regard to the term "gross income" as applied to miner-producers of tiles, bricks, cement and chemical grade Limestone.

1) A Supreme Court decision (*U.S. v. Cannelton Sewer and Pipe Company,* 5 AFTR 2d 1773, — U.S. —) held that the taxpayer was not entitled to compute percentage depletion on the basis of gross income from the sale of the finished product.

2) The Public Debt and Rate Adjustment Act of 1960 included provisions establishing "cut-off" points for calculating percentage depletion for many of these industries for years beginning after December 31, 1960.

In defining "gross income from property" as the proceeds (net of royalties and severance taxes) the term severance taxes refers to "ad valorem taxes paid on behalf of the lessor" and not to taxes applicable to the lessee's share of production.

The writer acknowledges with thanks the comments of several colleagues that accumulated earnings are not reduced by any depletion other than "book cost depletion" nor are they reduced by return-of-capital distributions.

HARRY I. COBERN, CPA
(Rosenthal, Shepard & Cobern)
New York, N. Y.

THE PRESIDENT'S PAGE

Meetings

One of the most effective and satisfying means of continuing education is attendance at our general and technical meetings. Those of our members, who were present at our general meeting of October 4th, heard Commissioner of Internal Revenue Dana Latham deliver a well prepared half-hour address, which he followed with a complete and frank discussion for another full hour of numerous questions, from all directions, affecting the administration of the Internal Revenue Service, and of the federal tax laws. I have no doubt that all these members left feeling that their time had been well spent. They enjoyed a very rewarding experience.

Why, under these circumstances, do so many of our members pass up such worthwhile opportunities to keep current and enhance their knowledge? I have heard some say that they can later read the papers in The New York Certified Public Accountant. But all the papers presented are not published. And when they are, months may elapse. Then some may not be read. Some of the best addresses are made from notes, rather than from prepared papers. The meatiest and most practical areas covered in such talks may never appear in print.

The question and answer period, which is written up only on the rarest of occasions, can frequently be by far the most educational part of the meeting. Of equal, if not of more significance, is the discussion after the meeting, on the spot, with both your fellow CPA and the speakers, exchanging experiences, elaborating upon and clearing up matters that may have been covered only generally, or not even mentioned during the meeting.

Our general meetings in November, December and next April should be at least equally rewarding. Some of our technical meetings have already been held. They have been very satisfying. Those planned from November through May have been scheduled at times, intervals and places to encourage attendance. Seminars also are being programmed and should be very inviting.

Our chapters as well have devoted countless hours planning meetings with informed and able speakers, principally from our own competent membership, to cover the most important areas in accounting, taxes, management services, estate planning, relations with bankers, credit men, and educators, and other significant subjects of current interest. The efforts of our chapters have been so well received that, on more than one occasion, repeat performances in other sections of the State have been called for.

The enthusiastic reception which was given to our meeting both in the Metropolitan Area, and at the Statewide conference, dealing with accounting problems in the preparation of the federal estate tax return, left no doubt as to its current educational and informative value. It was merely representative of many other meetings of equal significance.

Continuing education is one area that should always properly be in the forefront. And the importance of securing the benefits afforded by our meetings to our membership cannot be overemphasized. That prompts me to again stress the value of our meetings to you, and to invite and encourage your attendance to as many meetings as possible in your own interests.

BENJAMIN GRUND,
President

Economic Challenge of the Decade

By Roy L. Reierson, CPA

Although the economy since World War II has been characterized by greater cyclical stability, the inflationary bias in our economy represents a major problem. The economic challenge of the 1960's is two-fold: to maintain a satisfactory rate of growth of the American economy, and to preserve the American dollar. The remedies to the pressures of the decade, the author suggests, will involve exercising effective restraint on government spending programs, continuing a flexible credit policy, and gearing wage increases to productivity improvement.

THERE are probably few in this country today who need to be reminded that we are living in a revolutionary world in which powerful forces of change are at work. Breathtaking technological advances are transforming the dreams of only a few years ago into commonplace realities, and this has already led to economic as well as political and social problems for which the world is ill prepared. Here at home, our greatly improved national well-being has been accompanied by a corrosion of family ties and other new social tensions of many kinds. Abroad, we see the so-called underdeveloped countries aspiring to attain in a matter of a few years that for which others required many decades and even centuries.

This is, of course, not the first period of far-reaching economic and social change in the world's history, but never before perhaps have the forces been as powerful; never before have they swept across the entire face of the globe so swiftly; never before have they encompassed so many areas of human endeavor. Consequently, it seems timely to take stock of some of the major trends in the American economy—the road we are traveling, the direction in which we are moving, and the crossroads we may encounter along the way. The decisions which are made concerning our economy in the coming years will be crucial in determining the pace of our progress and our way of life, not only in the decade of the 1960's but perhaps even beyond.

ROY L. REIERSON, CPA, is Vice President and Chief Economist of Bankers Trust Company, New York. Dr. Reierson, who holds a Ph.D. degree from Northwestern University, formerly served on the faculty of the Graduate School of Business Administration of New York University and as consultant to the Board of Governors of the Federal Reserve System. This article has been adapted by the author from a paper presented by him at the May 1960 Annual Meeting of The New York State Society of Certified Public Accountants.

We have drawn the curtain upon the "Fabulous Fifties," as they are so often called, and now stand at the threshold of the widely heralded "Soaring Sixties." Actually, these labels are probably more descriptive of our national penchant for superlatives and alliteration than of the real character either of the past or the coming decade. However, while a 10-year milestone on the calendar does not necessarily mark a division between two distinct periods in economic history, it does provide a vantage point from which to view both the past and the future in some perspective.

RISING POPULATION AND LIVING STANDARDS

One of the most dynamic factors in our economy today is the sharp rise in population. We hear so much about the "population explosion" overseas that we tend to overlook our own rate of population growth, which is among the highest in the world. During the past 10 years, the United States population has increased by almost 30 million, or more people than were living in our 20 largest cities in 1950, and is currently expanding by some 3 million a year.

This tremendous upsurge in population has brought growing demands for goods and services of all kinds—for homes and highways, schools and churches, machinery and household appliances, automobiles and baby carriages. The rapid increase in the number of people in this country seems certain to continue; in fact, even the lowest official projection for the next 10 years envisages further population growth by almost 13 percent, while the highest projection is for an increase of more than 20 percent.

Despite this great growth in the population, the standard of living has continued to improve as production has expanded more rapidly than the number of people, and the purchasing power of income, per capita, has advanced by about 20 percent over the decade. Furthermore, these gains are being ever more widely shared; steeply progressive taxes are taking a heavy toll from high incomes while rising wages and social benefits of various kinds are bolstering the incomes of many millions at the lower end of the scale.

Assuredly, poverty and want have not been completely conquered, but the levelling of incomes has made great strides in our time. Indeed, one of these days we may be forced to ask ourselves whether this trend toward economic egalitarianism is to continue indefinitely, or whether providing greater incentives and rewards may not help us achieve greater and more rapid economic progress.

CYCLICAL STABILITY AND INFLATION

Our economic well-being since the end of World War II has been aided importantly by the absence of the typical "boom-bust" pattern of business fluctuations. So far, we have been spared those widespread speculative splurges, financed on credit, which in earlier periods of our history have repeatedly brought the economy to grief; and for this we owe some thanks to the good sense of the public as well as to the credit policies followed by the Federal Reserve. Neither have we had severe and sustained business recessions. Each of the three cyclical declines in business in the postwar era has been relatively brief and mild, and each was soon succeeded by a resurgence of employment and output to new peaks.

Obviously, the problem of cyclical fluctuations in economic activity has by no means been completely solved. The business cycle continues to be

a puzzle to economists, and much is still to be learned and discovered. Nevertheless, if we remain reasonably successful in moderating cyclical ups and downs, we shall have gone a long way toward averting and alleviating our economic problems on the road ahead.

That we shall encounter problems is a foregone conclusion. One major problem is the inflationary bias in our economy. Over the past 10 years, the American dollar has lost about one-fifth of its value, as measured by the rise in living costs. As regards safeguarding the value of the dollar, the record of the 1950's can give us neither comfort nor pride. For a time, we deluded ourselves into believing that the rising trend of prices—that is to say, the declining purchasing power of the dollar—was a consequence of World War II and, to a lesser degree, of the war in Korea. Throughout economic history, the mobilization of an economy for war has inevitably left strong inflationary pressures in its wake.

By the middle of the past decade, however, the postwar shortages, which had ranged from nylon stockings and rubber tires to railway cars and industrial equipment, had been made good; nevertheless, prices at that time embarked on a new and vigorous advance. This renewed rise could no longer be attributed to the aftereffects of war, but represented instead the consequences of our propensity toward ambitious government spending programs, our disposition to borrow and spend rather than save and invest, our practice of raising wages faster than output, and other habits and characteristics which have become entrenched in our economy and our society.

THE BALANCE OF PAYMENTS

Recently, the effects of inflation have begun to spread beyond our domestic economy and have shaken the position of the United States dollar in the world. While production costs here at home have been rising steadily, foreign countries, particularly those of Western Europe and Japan, have added to their industrial capacity and improved their productive efficiency to a point where they have become able to compete aggressively in world markets. Our commercial exports have suffered in consequence, imports of foreign manufacturers have soared, and there is an increasing tendency among American producers to shift operations abroad in order to gain the advantage of lower labor costs which their foreign competitors now enjoy.

As a result, a balance of payments problem has emerged for the United States. For a great many years, we have been paying out more abroad than we have received, largely in the form of foreign aid and investment. In the early postwar period, this had the desirable effect of helping foreign countries to rebuild their economies, restore their monetary reserves, and reestablish their currencies. In the past two years, however, our international deficit has expanded considerably, the standing of the dollar has come under suspicion in foreign markets, and some $3\frac{1}{2}$ billion of gold—over 15 percent of our gold stock—has been withdrawn.

Currently, the balance of payments appears to have improved somewhat; this year, our deficit on international accounts will be lower and the outflow of gold has dwindled. Also, we still have a larger gold reserve, by far, than any other country; in fact, we probably hold about 40 percent of the entire monetary gold stock of the world, including the unreported holdings of the Soviet Union. The underlying problem in our balance of payments, however, has not been corrected, and will surely rise to plague us again in

the years ahead unless we take the necessary steps to restore and maintain confidence in the dollar at home and abroad.

ECONOMIC GROWTH

This taking stock of where we stand shows that the American economy has expanded sizably in the past 10 years, and that the ingredients are at hand for strong further growth of population, production and material welfare in the next decade. At the same time, there are some deep-seated and disturbing problems in our economy; the consequences of sustained inflation, long deferred and covered up at home, have finally begun to make themselves felt on the international scene, where the dangers to the United States are more serious and the penalties more severe.

Looking to the future, we thus face two broad and basic tasks. One is to maintain a satisfactory rate of growth of the American economy. The other is to preserve the American dollar. The two are, of course, interrelated. The successful promotion of long-term growth will provide the means not only for the continuous betterment of the standard of life in the United States, but also for strengthening our world position. Conversely, the prospects for achieving solid, sustainable economic growth are poor indeed without effective defense of the dollar against inflation.

Vigorous economic growth has been an intrinsic feature of American history; our long record of industrial expansion and rising living standards is unmatched by any other country. Recently, however, some uneasiness has developed lest our growth be inadequate to meet the needs of the day, and preoccupation with economic growth has spread from the pages of economic journals to the arena of political controversy. This concern over growth reflects a curious mixture of motives.

To some extent, the desire for faster economic expansion emanates from the anxiety over what is felt to be a lag in providing public facilities, such as schools and hospitals, and in developing our resources at a pace commensurate with the swift rise in our private living standards. More rapid growth in total output would enable such needs to be met without slowing down the output of consumer goods. Also, it has been noted that American economic growth in the past decade compares poorly with the remarkable progress of many foreign countries, notably Japan, West Germany and Italy. And, finally, there is increasing apprehension over the reportedly more rapid industrial expansion of the Soviet Union, which suggests to some that our leadership of the free world may be in jeopardy.

Unfortunately, while the call for greater growth is widespread, there is little agreement concerning the sector or sectors of the economy which should be expanding most rapidly, or by what means growth should be stimulated, or even how economic growth should be measured. Over the long term, output in the American economy appears to have increased at an average rate of about 3 percent a year, but with wide variations from year to year and even from decade to decade. Economic growth, as biological growth, is a highly involved process, and we cannot say with authority whether growth should be constant, or whether changes in pace are not a necessary and constructive part of long-term economic development. Neither can we determine with assurance what rate of growth is likely to be in our best interests in the years and decades ahead—that is to say, what rate of growth is most conducive to solid and sustainable progress.

THE BASIC PREREQUISITES FOR GROWTH

Reduced to elementary terms, the rate of economic growth depends upon such basic factors as the number of people working to produce goods and services, the number of hours worked, and labor productivity which is essentially the amount produced by each worker in each hour. Another strategic ingredient is the provision of more efficient machinery and equipment, for it is this that enables human labor to become more productive.

In these respects, we enter the new decade with much in our favor. The labor force is in a rising trend. The so-called baby boom of the 1940's promises sizable increases in the working population in the years ahead, so that whereas in the past 5 years additions to the work force have averaged around 800,000 annually, they are now running close to 1 million, and may be at the 1½ million mark by 1965. At the same time, American business management, which for years has been aggressively expanding its plant and equipment, is continuing to spend huge amounts to modernize facilities and is, moreover, appropriating ever larger amounts on research designed to develop new products and better techniques. Consequently, we have the fundamental ingredients for further substantial growth in the decade ahead, and possibly at a brisker pace than in recent years.

The crucial question, however, is whether we shall make full use of this favorable potential. Some, fearful that a growing labor force and increased productive capacity may lead to overproduction and unemployment, would keep labor and capital in uneconomic uses, retain wasteful practices described as "featherbedding," and resist efforts to improve productivity—all of which obviously retard growth. Some would seek to accelerate growth by the record shows that some government spend more money, even though the record shows that some government programs merely add to payrolls without contributing to a more productive use of our resources, while other types of government spending, because they encourage keeping resources employed where they are less productive, actually hamper economic progress.

Unfortunately, there is no simple or easy prescription for stepping up the nation's growth. If we are indeed serious in our desire to see our economy grow more rapidly, we shall need to invest more and spend less—that is to say, we shall have to spend proportionately less on consumer goods and save more to invest in the further expansion and modernization of our productive plant, without which continuing increases in productivity will not be possible. We shall have to devote more attention to building a healthy, trained and skilled labor force and aggressive, imaginative and competent business managements. We shall have to stimulate competition and allow market forces to bring about a more efficient use of our resources, which means encouraging, instead of inhibiting, shifts of labor and capital out of less economic activities into industries where productivity is greater.

The prerequisites for rapid growth in a free society are not always welcome. That there is no comfortable substitute for hard work invariably comes as a distressing conclusion, no matter how deeply we know it to be true. Each of us, as members of the economic community—student, farmer, teacher, business man, professional man, employer or employee—has some special economic interest he is reluctant to compromise. Yet, as has been demonstrated repeatedly in the past and is now again being evidenced in other parts of the world, if we are to

raise our sights, we must be ready to make sacrifices today before we can aspire to the benefits of tomorrow.

MAINTENANCE OF A STABLE DOLLAR

Closely linked to the encouragement of economic growth is the maintenance of a stable American dollar. In our economy, the prices of individual goods and services must be free to move up or down in response to the forces of demand and supply; this is part of the mechanism which induces labor and capital to be put to the most productive use. Continuous inflation, however, has exactly opposite effects.

Inflation, as we have seen, penalizes saving, encourages borrowing and spending, and rewards speculation—all of which is precisely the opposite of what is required to promote energetic economic growth. Moreover, inflation falls with special harshness on education, medical care, and public services of many kinds which provide the sinews for economic growth, but which cannot easily pass on their higher costs to the ultimate consumer or beneficiary. Also, since inflation bears most heavily upon persons of modest means, including those living on savings and pensions, it tends to encourage political instability, as has been well documented in many foreign countries over the years. Eventually, inflation erodes the economic strength of a nation in relation to the rest of the world; this is another harsh fact which many countries abroad have discovered and which we too have recently begun to learn.

While inflation has exacted an even heavier toll in other parts of the world than it has in the United States, nowhere has it been demonstrated that an inflationary trend is conducive to faster economic growth. On the contrary, in many instances inflationary pressures have constituted the foremost obstacle to the fuller development of a country's economic potential. Within the past decade, the countries especially of Western Europe have made strenuous and, for the time being at least, successful efforts to bring inflation under control at the same time that they have achieved particularly swift economic progress.

At present, there is some feeling that in the United States, too, the inflationary trend has reached its end. This belief is based on the emergence of ample productive capacity, more rapid growth of the labor force, the cumulative effects of credit policy, and the currently improved outlook for the federal budget. However, many important groups in our society continue to prefer, or at least tolerate, inflation because it makes it easier to obtain higher wages, higher prices, or speculative profits, and because it lightens the burden of outstanding debt. Others, although critical of inflation, nonetheless favor government policies and activities that cannot fail to have inflationary consequences. With living costs and industrial commodity prices inching ahead to new peaks, we need to remain on guard against the inflationary bias so deeply rooted in our political, economic and social structure.

THE FEDERAL BUDGET

Despite this year's improvement in the Treasury's position, the federal budget continues to pose the greatest single threat to the stability of the dollar. The world's financial history is replete with instances of currencies that have foundered on budget deficits. In the United States, the role of the Federal Government in the past three decades has expanded enormously in virtually every sphere of activity, and with this has come a tremendous increase in government outlays. Although the greater share of government spending still is for defense, the

bulk of the increase in recent years has been for non-military purposes, notably agriculture, veterans' benefits, labor, housing, and other welfare programs; and further huge spending proposals are pending in the Congress today. Part of such spending may be essential to a stronger economy and a better life, but much represents a waste of resources which could and should be more productively employed.

While the pressures for greater government spending are certain to continue, our taxes, which today are taking a larger share of national income than even in wartime, are about as high as public opinion will tolerate. Put bluntly, this means that we as a people are demanding more services of government than we are willing to pay for in taxes. In fact, the hodgepodge of exemptions, concessions, and special treatment built into our tax system may be a signal that the tax burden is already higher than is consistent with maximum economic efficiency in the nation's business, and to the extent that this is so, it represents a further drag on our economic progress.

In seven of the past ten fiscal years, the Federal Government has run up sizable, and occasionally tremendous, budget deficits, and in only one year —in 1951—has a surplus been more than nominal. Moreover, since in an inflationary environment savings tend to fall short of total demands for capital, the Treasury has been unable, and continues unable, to attract sufficient investment funds to cover its deficits. As a result, the Treasury is forced to rely upon short-term credit to cover its needs, thereby adding to the inflationary potential of the economy from the side of the monetary system.

BULWARKS, PRESSURES AND REMEDIES

Fortunately, the American economy in the past decade has had one bulwark against the extremes of inflation. The Federal Reserve, by following a flexible credit policy, has not only helped to moderate fluctuations in business activity but, by restraining excessive expansion of credit, has also contributed effectively to the struggle against inflationary pressures. Today, however, the Federal Reserve is being besieged by critics who, impatient with restraint, advocate a liberal credit policy designed to make funds readily available to would-be borrowers, and at reduced interest rates. Should the Federal Reserve be compelled to abandon its flexible credit policy, it would be a step backward in the battle against inflation. This would enhance the prospects of a repetition of the speculative booms we have had in the past, make it more difficult to cope with the next business recession and, by encouraging borrowing and spending at the expense of saving and investing, reduce the chances of vigorous, sustainable economic growth. A combination of a chronic easy-credit policy and large budget deficits certainly would shake confidence in the dollar at home and abroad. Growing distrust of the dollar, which is a key currency in the international economy, would be a serious blow to the entire free world.

Finally, but importantly, inflationary pressures continue to be enhanced by the large regular wage increases that appear to have become accepted as part of our way of life. In and by themselves, rising wages are not inimical to economic growth; on the contrary, higher incomes are one way to make available to the American people the benefits of greater productivity and higher output. Recently, however, labor has come to pre-empt not only all of the gains in productivity, but has driven wage bargains which have resulted in labor costs increasing more rapidly than indus-

trial productivity as a whole. As a result, no room has been left for an additional return to the investor whose savings furnish the equipment for the rise in productivity. Nor has there been any room for price cuts to benefit the general public which provides the mass markets that make for more efficient output; lower prices should be, and in the past have been, another means for enabling the public as a whole to share in the results of America's economic progress. Instead, the wage push has led to repeated upward thrusts upon the cost and price structure of the entire economy.

To describe these trends and pressures is to indicate the remedies: exercising effective restraint on government spending programs, continuing a flexible credit policy, and limiting wage increases, at most, to the average pace at which productivity improves for the economy as a whole. As in the case of policies designed to promote economic growth, the requirements for defending the dollar are not altogether cheering to those accustomed to an easygoing life. Nevertheless, other countries have mustered the determination to come to grips with these problems in order to build for a better future. Should we lack the courage or energy to do the same, it would be a wry epitaph on what we so proudly regard as the American way of life.

What Constitutes Education?

Our word "education" is a misnomer. We are not educating; we are domesticating. To educate is to develop latent capabilities so that one may be strong to overcome the hampering obstacles of prejudice and environment in reaching out for truth. To domesticate is to train one to accept the prejudices, and to obey the conventions, of his environment. To educate is to develop free activity. To domesticate is to train to a prescribed end for a prescribed purpose. The domesticated animal, whether a biped or a quadruped, believes what he is made to believe, and does what he is made to do. The educated being believes what appeals to his reason, and thinks for himself. To educate is to teach people how to think; to domesticate is to teach people what to think. The processes of domestication, toward which we are drifting, make for small, narrow, and prejudiced minds.

Thomas S. Clarke, from a Symposium in The Rotarian

Construction Contractors--Examination of Financial Statements

By RICHARD S. HICKOK, CPA

The independent certified public accountant will encounter many unique problems in the course of the examination of the financial statements of a construction contractor. The greatest difficulties usually exist in the following areas: accounts receivable, including retained percentages; raw materials and supplies; accounts payable; and costs incurred on contracts in process.

THE accounting and auditing problems in the construction industry present a signal challenge to the accounting profession—one which has, until fairly recently, been somewhat neglected. A review of the published financial statements of contractors indicates the need for greater uniformity and clarity in statement presentation. It is also reasonable to assume that the auditing techniques followed by independent certified public accountants in the examination of contractors' accounts are likewise a proper subject for review in the light of the unique problems involved.

This article has been prepared to set forth a guide to certain of the unusual auditing procedures the independent certified public accountant should consider in the examination of a contractor's financial statements. It is not intended as a complete audit program but rather as a brief outline of the peculiar features of an audit of a construction contractor's accounts.

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GENERAL FEATURES

The CPA should be thoroughly familiar with the contractor's system of internal control and accounting procedures. Although familiarity with the client's control and accounting records is not unique to this type of engagement, it is of particular importance in a contractor's operation and there are certain control areas which are somewhat peculiar to the industry. The auditor therefore should have a working knowledge of these controls and procedures so that he may determine the extent of auditing tests which will be required.

The nature of the construction industry is such that the auditor must have an intimate knowledge of the con-

tractor's operation and should be familiar with all major contracts completed during the period under review or currently in process. To accomplish this, and before commencing the actual audit, the auditor should read all major contracts currently in process (or completed during the period). Pertinent details should be extracted from the contract (and the related contract file) and maintained in a permanent file for reference throughout the current audit (and subsequent examinations if contracts are of a long-term nature).

These contract permanent file work papers should indicate all pertinent information such as the following:

1. Type of contract (i.e., excavation, grading, erection, etc.).
2. Contract price (i.e., fixed price, unit price, cost plus fixed fee, guaranteed maximum price, etc.).
3. Escalation features, if any.
4. Terms of payment.
5. Cancellation features.
6. Estimated costs by contract components and original estimated profit.
7. Renegotiation status.
8. Unusual contract features (such as penalty for failure to complete as scheduled, and abnormal performance guarantees).
9. Bonding and insurance requirements.

For those contractors where the use of subcontractors is an important phase of the operation, the auditor should also consider reviewing contracts with subcontractors in the manner previously described.

Although the auditor will encounter many unique problems on a contractor's audit, the greatest difficulties usually exist in the following areas: accounts receivable, including retained percentages; raw materials and supplies; accounts payable; and costs incurred on contracts in process.

ACCOUNTS RECEIVABLE

A contractor's receivables include amounts currently receivable on completed and uncompleted contracts, and retained percentages. The latter represent amounts withheld from payment by the party for whom the work is being done, and these amounts may be withheld until the job is completed or even longer in the event certain contract guarantees must be fulfilled. The contractor's accounting records should provide for separate control accounts for these two types of receivables, inasmuch as retained percentages are subject to restrictive conditions. This is desirable for management and internal statements, and also for auditing purposes.

Trade receivables should be aged as of statement date. Similarly, retained percentages should be classified as due or not due. Delinquent balances should be very carefully investigated by the auditor. This investigation, which should include discussion with appropriate engineering personnel as well as financial management, may disclose information of the following nature:

1. Costs billed on cost-plus type contracts are being disputed.
2. Certain types of billings are to be revised to retain customer goodwill.
3. Equipment is not meeting contract guarantees and "make-good" costs are anticipated.
4. Amounts are not being billed in accordance with the contract.
5. Billings for contract extras are in dispute.
6. Contract cancellation, or postponement.
7. Credit difficulties.

The auditor should ascertain that adequate valuation reserves have been established for possible future adjustments as might arise from items of this nature.

The usual procedure with respect to direct verification by confirmation should be used by the CPA with respect to both amounts currently receivable and retained percentages. In confirming the amounts receivable, the CPA should also give consideration to confirming additional information, depending upon the contract, such as: total contract price; total billings to date; and advance payments.

The auditor must also make sufficient tests to ascertain that billings are being made in accordance with contract terms. In addition, he should ascertain by a test of billings that retained percentages are being billed and recorded as a receivable, and are properly classified as due and not due on the aging schedule.

As previously mentioned, retained percentages are often not collected until the expiration of a guarantee period, or until acceptance by the purchaser. The examiner should ascertain that adequate provision is made for fulfillment of contract guarantees. The accrual for such expenditures may be deducted from retained percentages (rather than being shown as a current liability) in the event that they are not definite liabilities payable to a specific creditor.

RAW MATERIALS AND SUPPLIES

During the phase of the examination involving raw materials and supplies, the auditor should cover the following points in addition to the more standard procedures: obsolescence, excess materials, and usage.

Obsolescence and inactivity. Technological advances in certain types of construction will often render obsolete substantial stocks of raw materials. The auditor should observe stock activity, and review this problem with the contractor's engineering personnel.

Excess materials on contracts. The auditor should thoroughly review the contractor's procedure for disposing of excess materials on contracts. The contractor should not accumulate an inventory of usable materials held at no value and, conversely, unusable materials left over from completed contracts should not be included in the inventory. In addition to the problem of over- or understatement of raw material inventory, gross profit on completed contracts may be misstated by the contractor's failure to establish an adequate procedure for handling this material.

Usage of raw materials. The charges to contract costs for materials will frequently represent both material purchased specifically for a contract and the usage of materials carried by the contractor as raw materials and supplies. Although it is customary to charge contracts in process with the value of materials purchased for specific contracts, the auditor should ascertain that charges for usage of the contractor's own raw materials and supplies inventory represent materials actually placed in process (or physically segregated).

ACCOUNTS PAYABLE

In the audit of accounts payable, the CPA should ascertain that this liability account includes both amounts currently due and retained percentages due subcontractors and other suppliers.

The auditor should reconcile statements received from vendors with the accounts payable records for all major suppliers and subcontractors. In the event statements are not received from principal suppliers, the auditor should give consideration to the possible use of confirmation requests. In addition to requesting confirmation of the liability due to the supplier or subcontractor as of the examination date, pertinent portions of the purchase order or subcontract might also be confirmed.

The auditor should also determine whether the voucher register has been held open for a period long enough to record all billings from subcontractors for the final month of the period under examination. This may be accomplished fairly simply if the auditor prepares a check-off list for all major subcontractors and ascertains that the final billing for the period has been recorded.

Contracts with subcontractors may provide for billings based on percentages of completion rather than on a monthly settlement. The status of the work as of the statement date may be such that no billing as of that date may be received from the subcontractor. The liability to such subcontractors should be recorded nevertheless, even if estimated. Contract status reports indicating the progress of each phase of the work will be helpful to the auditor in determining the reasonableness of these estimates.

The detail accounts payable trial balance should, of course, be thoroughly reviewed. The presence of noncurrent items and debit balances may suggest unusual situations and should be carefully investigated.

CONTRACT COSTS

The major problem encountered by the auditor in the examination of a contractor's financial position is in the audit of contracts in process. This is true whether the contractor's accounts are maintained on the percentage of completion basis, or on the completed contract basis. An active contractor will have in progress a number of contracts in varying degrees of completion. The auditor must determine the exact status of all contracts in process as of the date of the examination. The problem is how this may best be accomplished.

As previously mentioned, the auditor should be familiar with the contract terms on all major contracts. In addition, to properly evaluate the status of contracts in process, the auditor must have an intimate knowledge of the contractor's "modus operandi." After gaining familiarity with the contractor's operations, the auditor must decide what audit procedures are to be used to determine the status of the contracts in process. The extent of the review and test check of the profitability of contracts, cost records, billings, contract progress, etc., will depend to a great extent upon two important factors, namely, the adequacy and reliability of the contract cost records, and the extent to which this cost information may be compared with the contractor's original estimates used for bid purposes.

The auditor should test the charges to contracts in process and the extent of the tests must be based on the adequacy and reliability of these records. In testing the costs accumulated, the auditor should be alert as to the following contract charges and related features.

Charges accumulated on cost-plus type contracts which are not reimbursable. Such charges should be segregated on the contractor's cost records.

Excessive charges for contractor's equipment used on the job site. The rates charged to contracts for equipment used on the project should be designed to cover all applicable costs.

Charges for rented equipment with option to purchase. Contractors frequently rent field equipment with a purchase option clause, the rental payments applying against the purchase price. Equipment rental charges and related rental contracts should be reviewed. Gross profit can be misstated by acquiring fixed assets in this man-

ner and charging the entire cost against a particular contract. The auditor should review the circumstances relating to construction equipment acquired in this manner, and give due consideration to wear and tear on the equipment at the job site, estimated future life, fair market value, etc., in determining the propriety of the contractor's accounting treatment.

Overhead allocation. The auditor should review the contractor's accounting policy with respect to overhead charged to contracts in process. The overhead applied on engineering and manufacturing should not be in excess of actual overhead, and the latter should not include elements of idle plant expense or other abnormal costs. The allocation of general and administrative overhead to contracts in process is occasionally justified to avoid distortion of the income statement. This is especially true of contractors using the completed contract basis of recognizing income. Any such allocation, however, should be carefully reviewed by the auditor.

To evaluate the status of contracts in process as of a given date, the auditor's program should be approximately the same regardless of the contractor's method of recording income. Before reviewing the exact status of each contract the auditor should obtain a schedule of the following for each contract in process: (a) estimated total contract price; (b) contract billings to date; (c) ratio of *b* to *a*; (d) estimated total contract cost (revised); (e) costs accumulated to date; (f) ratio of *e* to *d*; (g) original estimated contract gross profit; and (h) revised estimated contract gross profit. Although this information may not be readily available from the contractor's accounting records, it is a minimum required to determine the status of contracts in process.

This schedule will indicate contracts in varying stages of completion. The audit of contracts currently undertaken should include a review of the original bid estimate and estimated gross profit. The auditor should ascertain that these contracts have been taken with the normal rate of gross profit. In the event that newer contracts have been accepted at estimated profits lower than normal, the auditor should consider the advisability of disclosing this fact in his report as this will be reflected in lower earnings in future periods.

If the contractor records earnings on a percentage of completion basis, the profit recognized on contracts in the early stages must, of necessity, be based on the original job estimates. However, until such time as it is possible to project contract costs with a reasonable degree of accuracy, care should be taken not to place unduly optimistic reliance on original profit estimates. Because of the difficulties in projecting costs required to complete the contracts, especially during the early stages of the work, many contractors will reduce the estimated profit by contingency factors or even defer profit until a sufficient amount of work has been performed so that a reasonably reliable determination can be made.

In the examination of contracts under way and those nearing completion, the auditor should review the projection of the estimated final gross profit on each contract. Costs accumulated to date should be compiled in the same manner as the original contract estimate. Costs to complete all phases of the job should be projected, and the total compared with contract price. In reviewing the cost projections to complete the contract, the following types of records should be utilized by the auditor:

1. Comparison of accumulated costs with original bid estimate, by individual item on original estimate.

2. Commitment file for uncompleted subcontracting work.

3. Open purchase order file.

4. Independent architect's estimate of completion, if available.

5. Project engineer's estimate of completion.

In addition to the above review of available records, contracts should be reviewed with the contractor's engineering personnel who are familiar with and responsible for the contracts in process. Engineering personnel should be informed as to the purpose of this review in order to obtain the utmost cooperation, and their comments should be given consideration in the evaluation of contract profits. However, the auditor should not accept the cilent's estimates of contract profits without further independent review. In the event this review indicates that any contract will result in a loss, full provision should normally be made for these losses in the current period, regardless of the contractor's method of recognizing contract profits.

After the determination of contract profits, the auditor must further ascertain that the correct amount of contract profit is recognized in the current period. In the event the contractor recognizes profits on a completed contract basis, the auditor and the contractor must agree on what determines completion and apply this principle consistently from one period to the next. It is obvious that the failure to apply this principle consistently could result in a substantial shifting of income from one accounting period to another.

Contractors who recognize profits on a percentage of completion basis present an additional auditing problem, namely, the amount of billing and gross profit to recognize in the income statement. Accountants generally recommend that gross profit on contracts be recognized on the basis of percentage of completion; however for practical reasons contractors often recognize profit on other bases, such as: (a) percent billed to estimated total billings; and (b) percent costs incurred to estimated total costs. Although the contractor may use a basis other than the percentage of completion method for recognizing income, the auditor should ascertain that the results obtained from the method followed present a fair statement of actual operations in conformity with sound accounting principles.

Due to contract terms, billings and costs incurred are not often comparable with each other, or with the percentage of contract completion. When contract billings run ahead of contract costs, due to "over-billing," excess profits should not be in income, and billings not earned should be shown as a liability, under the caption indicating the nature of the account, such as "Advance payments." Conversely, costs incurred may justify the recognition of greater earnings than would be recognized under another basis such as the billing ratio method.

After completing the review of contract status the auditor should obtain a representation letter from the client. This letter should set forth the company's accounting policies with respect to contract profits, and a resume of the status of contracts in process. The resume of contracts in process should set forth the extent of the company's review and evaluation of contract profitability and should contain specific comments with respect to the major contracts. The letter should be prepared and signed by both the company's financial and engineering management.

Other problems unique to particular fields of construction and particular type of contract will be encountered on certain examinations, but the unique auditing problems remain constant; namely, the determination of gross profit, and the allocation of contract profits to the correct accounting periods for contractors using the percentage of completion basis of recognizing income.

JOB SITES

The magnitude and location of certain construction projects frequently require that the contractor maintain an office at the site, and some part of the contractor's accounting may be performed at these offices. Depending upon the size and location of the project, this accounting work at the site may be almost all-inclusive or it may be limited to basic records such as payrolls.

In view of the temporary nature of such offices, the accounting procedures and records are frequently unsatisfactory and internal control may be weak or nonexistent. For these reasons, it is often desirable that the auditor visit selected field offices, preferably on a surprise basis, to examine the accounting records and review internal control procedures. During this phase of the examination, the auditor should make sufficient physical tests by observation of the charges to contract costs to satisfy himself with respect to inventories. In addition, the CPA should consider paying off field personnel and making physical inventory tests of field equipment, as payroll padding and loss and pilferage of construction equipment may be a problem in the construction industry.

Larger contracting firms engaging in many projects simultaneously will ordinarily have internal audit staffs who are responsible for auditing accounting records and procedures at the job sites. In those instances, the independent CPA should satisfy himself as to the scope of the internal audit program and review the reports of their examinations during the period. In addition, the CPA should periodically accompany the internal audit staff during an examination to determine the effectiveness of these audits.

FINAL PROCEDURE

Upon completing the audit, and determining that the contractor's balance sheet and income statement fairly present the financial position and results of operations for the period, the independent certified public accountant has an additional responsibility. That responsibility is to insure that the statements, and related notes, set forth the contractor's financial position and accounting policy, in accordance with generally accepted accounting standards, and in a manner comprehensible to the reader.

Accounting Principles for Long-Term Construction Contracts

By William A. Blackmon, Jr., CPA

The choice of the basis to be used in accounting for long-term construction contracts—whether percentage-of-completion or completed contract basis—is not one to be made without careful consideration of factors here pointed out. Also dealt with are the difficult questions of retroactive adjustments, the treatment of general and administrative expenses, provisions for losses, and tax considerations.

The construction industry, one of the largest in our country, presents a number of special problems to those in the industry as well as to sureties, bankers, and certified public accountants. These problems have received authoritative attention recently, notably these contributions:

Articles in The New York Certified Public Accountant by Richard S. Hickok, CPA:

Internal Control for Contractors, July 1960

Construction Contractors—Examination of Financial Statements, November 1960

WILLIAM A. BLACKMON, JR., CPA, was formerly chairman of our Society's Committee on Contractors' Accounting and is author of the AICPA brochure "Generally Accepted Accounting Principles for Contractors." Mr. Blackmon is a manager in the firm of Price Waterhouse & Co. and a research associate for the AICPA's Committee on Cooperation with Surety Companies.

In 1959 the AICPA Committee on Cooperation with Surety Companies released two pamphlets constituting definitive works as of this date, namely:

Auditing in the Construction Industry
(Prepared by Richard S. Hickok, CPA)

Generally Accepted Accounting Principles for Contractors
(Prepared by William A. Blackmon, Jr., CPA)

This article is designed to reinforce and extend certain of the accounting principles relative to long-term contracts which have been set forth in the latter pamphlet.

METHODS FOR RECOGNIZING INCOME

The basis or method for recording income on long-term construction contracts presents special accounting problems because jobs extend over more than one fiscal year. The problem is further compounded for some by a

lack of understanding of the underlying principles of accounting as well as an unfortunate use of certain terminology which means different things to different people.

GENERALLY ACCEPTED METHODS

There are two generally accepted methods of accounting for long-term contracts:

a. The percentage-of-completion method — "preferable *when estimates of costs to complete* and extent of progress toward completion of long-term contracts *are reasonably dependable*."
b. The completed-contract method—"preferable *when lack of dependable estimates or inherent hazards cause forecasts* to be doubtful." (Emphasis supplied.)

These two methods are also the accepted ones for income tax reporting purposes (Regulation 1.451-3 adopted 12/24/57).

One often hears contractor accounting methods described as either the "cash" or the "accrual" method. Such terms are commonly intended to designate the "completed-contract" or "percentage-of-completion" method, respectively. However, to the accountant "cash basis" refers to the recording of transactions which have arisen from only cash receipts and disbursements in contrast with the accrual basis under which transactions are recorded when all events have occurred which fix the right to receive income or that establish the fact of a liability. Thus a contractor could, to an accountant, use either the "cash" or "accrual" basis, or even a hybrid basis, to record transactions under either the "completed-contract" or "percentage-of-completion" method. It is to be hoped that, with further education as to the hazards of confusion over terminology, the industry and interested parties will gradually adopt the more descriptive terms, and abandon the use of the terms "cash" and "accrual" which are less descriptive and possibly misleading.

The word "preferable" was used deliberately in the above definitions to indicate that, while there is a presumption in favor of the "percentage-of-completion" method where reasonably dependable estimates can be made, there is, however, a presumption in favor of the "completed-contract" method when dependable estimates are lacking or inherent hazards cause forecasts and estimates to be doubtful.

It is of course acceptable to use one method for certain contracts and another for other contracts, as appropriate. It may seem that a contractor who employs such a combination of accounting methods is being inconsistent. This is not the case. Consistency in application lies in according the same accounting treatment to the same set of conditions from one accounting period to another. The selection of a method should therefor be governed by a set of ground rules, consistently followed, in order that a mere whim or an intent to show predetermined results may not influence the method chosen. A literal reading of the applicable income tax regulations would seem to preclude the use of both methods simultaneously for tax reporting purposes. The indiscriminate or inconsistent employment of the two methods obviously would not be acceptable for either book or tax reporting purposes. In the view of the writer, the appropriate and consistent application of the two generally accepted methods simultaneously in computing taxable income may be assented to by the Treasury Department, under the general accounting rules of the Code, where they find no tax avoidance motive.

BILLINGS NOT INDICATIVE OF INCOME

It will be noted that the aforementioned definition refers only to "estimates of costs." It is sometimes suggested that billings constitute a basis for the recognition of realized income on partially completed contracts. Billings, however, may have no real relationship to performance under a contract. In many instances, knowingly or unknowingly, the contractor's client permits the earlier billings to be made in amounts which are excessive when compared with the work actually performed. This is a common means of providing working capital for the contractor and the arrangement is referred to as an "unbalanced bid or contract." In other instances, to protect the owner, the "on account" billings may be purposely kept below the costs incurred, and thus below the amount due for the work performed. It is more common, however, to protect the owner by "retainage," which is usually 10 percent of each billing, payable on completion of the contract. It will be observed from the above comments that *generally billings are not a suitable basis for income or profit allocation.* By using costs of comparable work previously performed a contractor may be able to arrange billings under a new contract in such a manner that an appropriate income allocation will result. This situation is obviously not one of mere chance, but in itself does not repudiate the fact that billings may have no real relationship to performance, whereas costs ordinarily do.

It is sometimes suggested, say in relation to a particular long-term contract or to a contractor having numerous long-term contracts, that the selection of one accounting method as compared with another will give a totally different picture of the financial position and results of operations. The inferences of such remarks parallel the old adage of "figures don't lie, but liars figure." However, a close reading of the comments on the selection of an accounting method indicates that the two methods are mutually exclusive for one specific contract. It is only with the benefit of that unbeatable crystal ball called "hindsight" that one can say following completion of a five-year contract, had it been recorded on the "percentage-of-completion" method instead of the "completed-contract" method the profit at the end of the first year would have been $10,000 instead of zero." This is obviously and only the statement of a "Monday morning quarterback."

PERCENTAGE-OF-COMPLETION METHOD

This method, which accounts for income on work as a contract progresses, has the advantage of periodically recognizing income on a current basis rather than irregularly as contracts are completed. It also reflects the status of incompleted contracts. The major disadvantage of this method is its necessary dependence on estimates of ultimate costs which are often subject to uncertainties.

The AICPA committee on accounting procedure recommends that income to be recognized in a contractor's accounts be either:

(1) that percentage of estimated total income that *incurred costs* to date *bear to estimated total costs* after giving effect to estimates of costs to complete *based upon most recent information, or*

(2) that percentage of estimated total income that may be indicated by *such other measure of progress* toward completion as may be appropriate *having due regard to work performed.*

The first of the above methods recognizes that, since work performed is the primary basis for income allocation, certain costs may be disregarded as a measure of performance in the early stages of a contract for the purposes of determining income allocation. The statement relative to "incurred costs to date" is further qualified as follows:

> *Costs* as here used *might exclude,* especially *during the early stages* of a contract, *all or a portion* of the cost *of such items as materials and subcontracts* if it appears that *such an exclusion would result in a more meaningful* periodic *allocation of income.*

This qualification takes into account circumstances in which substantial quantities of materials may have been accumulated on a job site but not used, or situations in which engineering or architectural fees have been incurred, which may, for example, represent 15 percent of total estimated costs when, in terms of work performance the contract was only 5 percent completed. In these circumstances income recognized as allocable to the period should be related to only 5 percent of the total, and not to the extent of 15 percent.

Many contracts require the expenditure of substantial sums for fees, financing charges, insurance, performance bonds and the like, often before any actual construction work is undertaken. Though these are necessary contract costs, such amounts may have no relationship to work performance and apply to the job as a whole. Such costs can best be deferred and amortized over the life of the contract for the purposes of determining income to be recognized under the "percentage-of-completion" method of accounting. The method for amortization of such charges can parallel the relationship of incurred work performance costs to total costs, exclusive of the amortizable costs. On the other hand, use of the "straight-line" amortization method, which is simpler to compute for such charges, may not necessarily distort income allocation.

The first method contains the qualifying comment which states "based upon most recent information." It is of course in keeping with this suggestion that periodic re-estimates of total costs and times for completion should be made. Such re-estimates should be determined at least annually, and more frequently where significant income distortions might result from failure to "up-date" a contractor's operating results. The redeterminations of total estimated costs, completion times, and their effect on profits or losses, should be handled in a practical manner bearing materiality in mind in a contractor's accounts during his fiscal period and further refined on or about his year-end.

The "percentage-of-completion" method also encompasses, as previously mentioned in the second alternative, the use of such other measure of progress, to measure work performed, where it is more appropriate than costs incurred to date. Such measures may be, for example, cubic yards of excavation for foundation contractors; or cubic yards of cement or asphalt laid for highway contractors; or engineering or architectural estimates of percentage of completion. Where a more meaningful allocation of income would result, it is not only permissible but it is more appropriate for one contractor to use different methods of estimating work performed on different types of contracts and different varieties of construction work.

RETROACTIVE ADJUSTMENTS

In applying the "percentage-of-completion" method the question is

raised occasionally as to whether to retroactively adjust prior periods' results based on the most current available estimates of the ultimate results to be realized. If this is done, final results for several accounting periods are obtained only when each job is completed. Such a procedure of readjustment assumes in the final analysis that profits or losses on individual jobs were rateably earned or lost in the proportions that costs were expended in the fiscal periods. The procedure also presumes that no unanticipated events occur during the course of a long-term contract which might be recognized as producing greater or lesser amounts of profits or losses in given periods of occurrence. Neither the construction industry nor the art of accounting are that mathematically precise.

There are rare occasions when retroactive adjustment of prior periods' results may be considered to be appropriate. Such occasions and the adjustments must be related directly to prior events to be reflected properly in prior periods. Further, the materiality of a possible retroactive adjustment should also be considered in determining whether a retroactive correction should be made.

Assuming that a contractor makes every reasonable effort under his estimating procedures to prognosticate ultimate profits or losses based on the then best available information, most adjustments which can be attributed to the many business hazards that occur during the course of construction work should be reflected in the fiscal period in which they occur or become known.

The continuous necessity for material readjustments of estimates suggests that either the estimating procedures of a contractor are inadequate or that the nature of the work performed is such that the next discussed method, the "completed-contract" method, may be more appropriate.

COMPLETED-CONTRACT METHOD

The second of the two generally accepted methods of accounting for long-term contracts is the "completed-contract" method. This method recognizes income only when a contract is completed, or substantially so. During the period of construction, billings and costs are accumulated, but no profits or income are recorded before the substantial completion of the work. A contract may be regarded as substantially completed if *remaining costs are not significant in amount.* It is to be observed that time is not the significant factor, but the remaining amounts of costs is the significant guide line. Final approval and acceptance will often occur months after substantial completion based on costs incurred. Seriously misleading results would occur if a contractor was not permitted to recognize income under this method at (say) his October year-end and was forced to defer the recording until November, or, worse still, until months later when the project was declared legally completed in accordance with local ordinances and codes. Secondly, good accounting aims properly to discourage a deliberate postponement of the recording of income on a contract by deferring the performance of some minor part of the work.

The second method's principal advantage is that it is based on results as finally determined, rather than on estimates for unperformed work which may involve unforeseen costs and possible losses. This method sometimes has a further financing advantage resulting from a deferral of income tax costs until cash realization. Its disadvantage is inherent in the fact that it does not reflect current performance when the period of a contract extends through more than one accounting year. Under such circumstances, the method may result in an irregular

recognition of income, and in some situations (for example, single proprietorships, or partnerships including joint ventures) it may, through an irregular recognition of taxable income, subject the individuals concerned to greater income tax liabilities.

GENERAL AND ADMINISTRATIVE EXPENSES

General and administrative expenses and similar general expenditures sometimes described as overhead or indirect expenses are commonly not accumulated as contract costs. Such expenses are usually treated as "period costs" (i.e., current expenses). Under the "percentage - of - completion" method, little difficulty is encountered because there is periodic recognition of income from which such items can be deducted. This may not be the case, however, when the "completed-contract" method is used. It also may be appropriate to allocate general and administrative expenses to contract costs rather than periodic income. An allocation may result in a better matching of costs and revenues than would result from treating such expenses as period costs, particularly in years when no contracts were completed.

The words "may be appropriate" are used deliberately since a contractor who employes the "completed-contract" method may be engaged in numerous projects and it may be preferable for him to charge those expenses to periodic income as they are incurred as no material distortion of net income would occur. However, if there is only one contract (or just a few contracts), and no income (or an abnormally small amount of income) is recordable on the completion of contracts in a specific period, seriously misleading results might be shown if general and administrative expenses were expensed as incurred in each accounting period. The election by the contractor to allocate general and administrative expenses to contract costs, like the selection of one of the two methods of accounting for contracts, should be governed by a set of ground rules, consistently followed. However, there should be no excessive deferring of overhead costs, such as might occur if total overhead were assigned to abnormally few or abnormally small contracts in process. When construction volume is at a low point, only a reasonably allocable or normal amount of overhead costs should be assigned to contracts in process. The remaining general and administrative or overhead costs should then be shown as period expenses even though net losses were thereby produced.

It is to be noted that there have been specific tax decisions involving general and administrative expenses in which it has been held that such expenses should be written off as incurred for tax reporting purposes. See, for example, A.R.R. 8367, III-2 CB, 57; *Brown & Root, Inc.* v. *Scofield* D. C. WD Texas 1953; 53-1 USTC para. 9361; 44 AFTR 1325.

PROVISIONS FOR LOSSES

When estimates of total contract costs indicate an ultimate loss, provision should be made for the entire amount of the loss on a contract. This principle is applicable to both the "percentage-of-completion" method and the "completed-contract" method, even though the latter does not permit the recording of income prior to completion. However, when several contracts are parts of the same over-all project, they should be treated as a unit in estimating profits or losses and in determining the necessity for a provision for losses. If this were not done, revenues and costs relating to the same over-all project might be recorded in

different accounting periods. There are circumstances under which a contractor may undertake work in phases and his profits or losses may vary markedly between say phase 1 and phase 3. Only phase 1 may have been formally contracted for, and, having an unbalanced series of contracts, that phase may be expected to result in a loss. In his accounting the contractor must properly be limited to that which he has contracted for, and thus a provision for loss would be called for in this situation. However, as the further related work materializes, it, together with the initial contract or contracts, should be looked upon as a whole in considering the necessity for a loss provision.

Ordinarily, a provision for loss on a contract should not be necessary unless the total estimated direct contract costs, plus general and administrative expenses where allocated, are expected to exceed the total contract price and then only to the extent such costs exceed the contract price. In determining the need for a provision for loss, the total general and administrative expenses that it is estimated will be incurred and allocated by the time of completion of the contract should be considered together with the estimated direct contract costs.

In computing the need for provisions for losses on contracts, penalty liabilities for indicated late completion should be included in total estimated costs. When the contractor is working on a "cost-plus" basis, unreimbursable costs—be they unauthorized in themselves or amounts in excess of those authorized or in excess of "guaranteed maximum costs"—should be considered in determining whether the contract is a profitable or unprofitable one. Under some circumstances consideration will need to be given to such other factors as escalation, change order extras, price redetermination, etc. On the other hand, incentive bonus provisions for early completion or for low costs should also be taken into account in determining the gain or loss status under contracts.

With the accrual basis of accounting, recognition is given to revenues, costs, and expenses, to the fullest extent possible in the periods to which they relate. As previously indicated, it is also, with the "percentage-of-completion method," a generally accepted accounting procedure to accrue revenues under certain types of contracts on the basis of partial performance if the circumstances are such that total costs and profits can be estimated with reasonable accuracy and ultimate realization is reasonably assured. With these principles and procedures in mind, the question is sometimes raised: Why not recognize the loss over the period of the contract? Assuming the exception commented on later in the next section is not applicable, it must be said that the accounting dogma of anticipating losses when they are reasonably determinable becomes dominant over the two aforementioned principles. In brief, the entire loss accrues at the time when the current estimates of total contract costs indicate a loss because such estimates indicate that the loss will not be recoverable from future revenues on a contract or group of contracts relating to the same project. Such being the case, there is no merit in postponing the recording of portions of a loss to the future. The accounting profession has taken a parallel position on the recognition of losses in dealing with such matters as inventory losses, losses on purchase and sale commitments, and unrealized losses on foreign exchange.

This query has been made: If the "completed-contract" method (rather than the "percentage-of-completion"

method) is selected as a result of a lack of dependable estimates of costs, are not the estimates equally unreliable for purposes of estimating an allowance for loss on a contract? The provision for a loss should represent, under either method, the best judgment that can be made in the circumstances. If "inherent hazards" are not present, it must be presumed that the "completed-contract" method is selected because there is no dependable estimate of costs. However, the selection and application of this method in accounting for the normal business operations of a contractor does not of itself preclude the fact that a loss will become clearly apparent at some stage of completion. The bulletin therefore uses the words "expected" loss to indicate that the actual realization of the loss should be reasonably certain. To "expect" or to be reasonably certain that a loss will occur, a contractor must be presumed also to be in a position to approximate reasonably the amount of such loss. The "long-established accounting practice of anticipating losses" referred to above, does not recommend arbitrary provisions for losses, but presumes the exercise of care and good judgment.

RENEGOTIATION PROBLEMS

Under some circumstances, government contracts and subcontracts are subject to renegotiation—that is, an adjustment of the original contract price with a refund, if found warranted, payable to the government. Provisions for renegotiation refunds are similar to other provisions for foreseeable losses on contracts to the extent that when such probable refunds can be reasonably estimated, liability therefor should be recognized in the financial statements. The amount of refund recognized by the provisions should not, however, exceed that applicable to billings recognized as income to that date. Provision for such refunds should be included in the statement of financial position among current assets or liabilities. When such refunds cannot be estimated, it should be disclosed that the contractor is unable to determine renegotiation effects, and that there are consequent uncertainties in the financial statements. Renegotiation provisions differ from other loss provisions in that they do not normally produce a contract loss but only a reduction in previously anticipated profits. Renegotiation refunds involve only a refund of "excessive profits." The accounting treatment of such refunds in the income statement also differs from other loss provisions which are shown as contract costs. Provisions for renegotiation should preferably be treated in the income statement as a deduction from contract revenues.

TAX CONSIDERATIONS

When provisions for estimated losses on uncompleted contracts are made on the books and in the financial statements, and such provisions are not currently deductible for income tax purposes, it would be proper to make such provisions "net of taxes." That is to recognize (at the estimated effective tax rate) the future tax reduction at the time or times that the loss is deductible. If this were not done, the contractor's income would be improperly reduced in one accounting period by, say, an amount equivalent to half the total provision for loss and the income would be improperly increased in the subsequent accounting period, or periods, by the tax effect of the deduction of the loss in that period or periods. By providing for the loss "net of taxes," the estimated net loss (i.e., after taxes) is properly reported in the accounting period in which the loss is foreseen.

Loss provisions "net of taxes" presuppose that there is other taxable income or "carryback" privileges then available at least to the extent of the deductible contract loss. Were this not so the contract loss would produce no reduction in income taxes and should not then be recorded "net of taxes." It would not be proper accounting to anticipate future taxable income and, assuming a "carry forward loss," provide for contract losses "net of taxes."

In computing the tax effect, the estimated rate should be based on rates in force during the period covered by the income statement with such changes as can be reasonably anticipated at the time the estimate is made. It is, of course, appropriate to consider the tax effect as the difference between the tax payable with and without including the loss as a reduction of taxable income. All significant income taxes, U.S. Federal, foreign, state and local, should be considered in the computation, and reasonable approximations in round figures will suffice.

Costs of Technological Progress

As the distinguished French economist, Jacques Rueff, has said:

> All economic progress is nothing, basically, except an incessant struggle between the call of the future and the defense of the past.

We achieve progress by changing ways of doing things and replacing new products for old. This involves costs of junking machinery, plants, and even entire industries, which progress has made obsolete. More important, it involves losses of old jobs and values of old skills acquired out of years of experience as new jobs and new skills are created. There are thus not only losses for investors but losses of jobs for people. In the past, we have accepted these costs of progress and that is an important reason why we have progressed so far. If we really want to speed economic growth, we will have to recognize and accept such costs.

The problem is symbolized by the so-called depressed areas where there are pockets of long-term unemployment. The tendency is to support these people where they are—and thus leave the problem unresolved—when the need is to encourage them to equip themselves for new and different jobs and, if necessary, to move where employment opportunities exist. The ability of the free society to survive and expand rests on the self-reliant adaptability of the individual.

First National City Bank
Monthly Letter—October 1960

Bank Accounting Practices

By GEORGE RICHARDS, CPA

The author contends that in a number of vital areas bank accounting practices deviate from generally accepted accounting principles. A further significant deficiency in bank accounting is the lack of uniformity since many banks may choose to handle phases of their accounting to serve individual purposes. The chief departures from accepted practice seem to lie in the areas of accrued income and expense, accounting for investment securities and fixed assets, and treatment of loan losses.

TAKING a somewhat negative approach, in comparing bank accounting practices with generally accepted accounting principles it is significant that we are dealing with variables escaping precise definition. Bank accounting lacks sufficient uniformity to permit mechanical reliance on any so-called standard procedures, while the meaning of "generally accepted accounting principles" raises questions of interpretation. Notwithstanding this, there is a great deal that can be done to improve accounting and financial reporting by banks. While these efforts may fall short of achieving everything that might be desired, the many opportunities for improvement are a definite challenge.

A significant deficiency in bank accounting is its lack of uniformity. As long as banks choose to handle phases of their accounting to serve their individual purposes, bank financial statements will have limited value in a comparative sense. This lack of comparability is a constant problem as the financial position and operating results as disclosed by the financial statements often leave many questions unanswered.

The presentation of the bank's financial position in its statement of condition is regulated closely. Supervisory authorities require the periodic filing of statements of condition and have promulgated regulations and rules regarding the classification of accounting information shown therein. Accordingly, balance sheet classifications have become relatively standardized, although there is considerable latitude in presenting asset stated values.

As supervisory authorities are primarily concerned with the protection of depositors, statement of condition presentation is influenced by an extremely conservative attitude with regard to asset valuation. It is significant, however, that statement of condition conservatism may have the opposite effect on the portrayal of bank earnings in the income statement. In fact, a comparison of the effect of bank accounting practices on the statement of condition and on the income statement will indicate far more objectionable

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accounting presentation in the latter.

While a certain degree of balance sheet conservatism might be excused, particularly if consistently applied, the basic question is, "Do bank accounting practices provide a satisfactory basis for the preparation of an informative statement of income?" In many cases the income statement does not meet this test.

What are the bank accounting practices that contribute to misleading presentation of earnings information in the income statement? Obviously, because of the diversity of accounting practices all possible situations cannot be covered, and in some areas it will be necessary to generalize. Here, then, are some of the bank accounting practices that are at variance with generally accepted accounting principles and tend to distort earnings.

CASH BASIS OF ACCOUNTING

A major deficiency is the predominant use of the cash basis method of recording income and expense. To some extent this is an accounting method borne of expediency. Banks must prepare a daily statement of condition, and accordingly it is necessary for the general ledger to be posted at the close of each business day. The bank must be in a position to prepare its financial statements almost immediately after the day's transactions have been recorded. This requirement influences its whole accounting system as the need for preparing financial statements on such an immediate basis makes it impracticable to hold accounts open for periods long enough to establish all expense and income accruals.

While this is a compelling, practical reason for using a simple form of accounting such as the cash basis, it does not alter the fact that an income statement prepared on this basis does not present a realistic picture of earnings. Larger banks in recognition of this have adopted certain accrual accounting procedures. Although the need for timely preparation of financial statements places some practical limitations on the extent of these accruals, a realistic approach can lead to the presentation of an earnings statement that in all material respects will be comparable to that resulting under a complete accrual method.

ACCRUAL OF INCOME

The principal source of bank earnings is interest income from loans and securities. Accrual of this income is essential to avoid distortions between accounting periods. This is particularly noticeable when cash basis accounting is applied to security income, because a substantial amount of this interest is collected at six-month intervals. Sources of gross earnings, other than interest, include service charges, safe deposit box rentals, trust fees, and loan and other service fees. From a theoretical standpoint this income also should be reflected on an accrual basis. However, a practical view will indicate that reporting such income on a cash receipts basis will not significantly distort earnings as this income tends to remain relatively constant. Of course, there would be individual situations that might nullify this approach, but generally speaking these items are not the ones that contribute to earnings distortion.

Various methods have been devised to provide accrual systems for interest income. Some of these systems are quite detailed and are designed for control purposes as well as to provide realistic accounting information. Moreover, it does not follow that all banks should use the same accrual procedures, as smaller institutions will find it economically unsound to employ all of the refinements of an elaborate system. There are, however, simplified

accrual plans that will place this principal gross earnings item on a sound accounting basis for preparation of monthly income statements.

ACCRUAL OF EXPENSES

On the expense side of the income statement the use of cash basis accounting also contributes to misleading conclusions on bank earnings. The principal areas where distortions are apt to occur are salaries, interest, and taxes. From a practical standpoint, if accrual concepts are applied to these expense accounts, in many cases handling the remaining expenses on a cash basis does not have an effect materially different from comprehensive accrual procedures applied to all expense accounts.

Salary expense is a major item in the bank income statement. Often it approximates over 30 percent of total expenses. While payroll periods frequently coincide with monthly income statements so that accruals are not needed to properly reflect salaries expense within the accounting period, each individual situation must be considered. The importance of the salary expense item makes this necessary if a realistic approach is to be taken in presenting this data in the income statement.

The second major item for accrual is interest expense. The importance of this expense has significantly increased in recent years concurrent with the rising trend in interest rates. Proper recognition of it in the income statement can only come about by systematic accrual.

Tax expense is customarily a major item in any business; yet in spite of this, there are still banks that handle this expense on a cash basis. It is difficult to think of any argument that could be raised to support this accounting treatment. Monthly provisions should be made for accrued income taxes as well as real estate and personal property where the latter are significant in amount.

Thus far the discussion has centered on some rather elementary accounting concepts. This would seem scarcely necessary except for the fact that, surprisingly enough, there are many banks that would do well to follow these modified accrual procedures. Too often we think only of the large financial institutions where accrual accounting has received acceptance. It is significant that there are approximately 14,000 banks in the United States, of which approximately 90 percent are small institutions where cash basis accounting is the rule rather than the exception. Thus, before considering the more sophisticated problems in bank accounting, it is appropriate that some recognition be given to the bank that continues to report its earnings on the basis of cash receipts and disbursements.

ACCOUNTING FOR INVESTMENT SECURITIES

We have made the point that bank earnings information must be on a modified accrual basis, at least to the extent of the more material income and expense items, in order to be realistic and informative when presented in the income statement. Now we will consider some of the other accounting matters that are apt to produce misleading inferences in the income statement. One of the more significant areas relates to the accounting for investment securities.

The argument has already been advanced for reporting security income on an accrual basis. This income is also subject to adjustment for amortization of bond premiums. Not all banks reflect this premium amortization as a reduction of interest income. Some follow the practice of writing off entire premiums to the undivided prof-

its account at the time the securities are acquired. Obviously, this procedure tends to distort security income; in the period securities are acquired as well as in other periods the absence of amortization charges leads to an overstatement of these earnings. Here, again, is an example of a departure from a fundamental rule of accounting. It seems almost unnecessary to argue in favor of its use except for the fact that so many banks completely ignore sound accounting in this area.

A less common accounting procedure in connection with security income is the accretion of bond discount. There are differences of opinion on the advisability of adopting accretion as an accounting policy, and for this reason it cannot be advocated in the same manner as premium amortization.

Some accountants question whether there is a violation of the generally accepted accounting principle that unrealized profits should not be credited to the income account. By amortizing the discount, the carrying value of a security is periodically increased predicated on the intention of holding it to maturity. It is argued that if it became necessary to sell the security prior to maturity, the increased amounts might not be fully recovered.

It is not the purpose of this article to take a position on the question of discount accretion; rather it is mentioned here merely as an accounting procedure that should receive consideration. While conservatism might be a sufficient argument for not adopting it, on the other hand a more serious error may result—that is, by failing to recognize the income element of the original discount, interest earnings during the holding period of the security may be materially understated.

Another matter that should be considered in the accounting for investment securities is the recording of profits and losses on security retirements. There are so many variations in accounting treatment accorded security profits and losses that there is no discernible pattern. Many banks record these profits and losses directly in the undivided profits account, and accordingly they are omitted from the income statement. It is obvious that such omission fails to disclose information that often is material in amount. The situation is further aggravated as the provision for income taxes often reflects the effect of these security transactions.

No attempt will be made to catalogue all the various accounting practices in recording security profits and losses; however, there are two fundamental rules to be recognized that should be mentioned. The first of these is that the income statement should disclose the net result of security transactions. This net profit or loss amount should appear in the statement directly below net operating earnings after provision for income taxes. The second important point is that such profits and losses should always be shown on an "after tax" basis. To do otherwise will often lead to distortions in the figure for operating earnings after income taxes.

TREATMENT OF LOAN LOSSES

Another accounting problem for consideration is the treatment of loan losses. It is well established that interest is in part a compensation for the risks inherent in loaning money. In arriving at net income from loaning operations it is illogical not to recognize loan losses as a charge against this income. Notwithstanding this, there are few banks that consider loan losses as an expense of doing business. The majority charge such amounts against the undivided profits account either as an addition to a loan loss reserve or by direct charge-off.

One of the reasons why additions to the reserve for loan losses are not charged against income is the difficulty of arriving at an equitable basis for such charges. The reserve for loan losses provides for possible uncollectible loans presently outstanding, and in addition contains an element of capital funds to provide for future loan losses. Its creation is intended to build reserves during good earning periods to offset losses that will have to be absorbed in deflationary periods.

It can be readily seen that establishing loan loss reserves by charges to undivided profits and then applying actual losses against these reserves overstates earnings since no recognition is given to these losses as a cost of doing business. While admittedly there might be some capital funds element in providing loss reserves, it would be more realistic to charge these provisions as an expense rather than to ignore any expense element as is presently done by many banks.

ACCOUNTING FOR FIXED ASSETS

Still another accounting problem relating to banks is the treatment of fixed assets. In an effort to be conservative, banks often charge off capital additions at the time of their acquisition. While this practice may present a conservative statement of condition, it has the opposite effect upon the income statement. This is readily apparent when the allowable depreciation for income tax purposes is compared with book depreciation plus the current direct charge-off of fixed assets. It is difficult to find any argument to support this practice as many times the difference between the stated value of fixed assets in the accounts and their depreciated cost for income tax purposes is not substantial. Moreover, the problem is further distorted by the income tax provision. When book and tax depreciation differ, the provision for income taxes is not always applicable to stated earnings. The only logical solution to this problem is to use one accounting basis for the depreciation of fixed assets. Only in this manner can the distortion of earnings be eliminated, and each accounting period receive its appropriate charge for the use of fixed assets.

CONCLUSION

The foregoing comments regarding bank accounting practices certainly do not propose new accounting procedures at variance with practices regularly followed by commercial and industrial enterprises. In fact, some of the points are so elementary that it is only logical to question why they have to be mentioned at all. Certified public accountants who are currently providing services for banks will recognize many of the accounting situations described; they will also be reminded of others that have not been mentioned. A fair-minded appraisal of the situation clearly indicates a need for a complete revision of accounting practices in many banks—particularly those procedures that affect the reporting of income.

It is submitted that we of the accounting profession have an obligation to the banks as well as to the users of their financial statements to take the leadership in correcting these accounting practices whenever they are encountered. As more banks utilize the services of the CPA in tax and audit matters, an opportunity will be available to make many constructive changes that will produce lasting benefits to the banking industry. Without realistic earnings information it is difficult to determine the direction in which the individual bank moves. In the last analysis this trend of operations is often more significant than the bank's financial position at any given point of time.

New York State Tax Forum

Conducted by PETER ELDER, CPA

REPORT OF TAX STRUCTURE STUDY COMMITTEE

The Tax Structure Study Committee, appointed by Governor Rockefeller in April 1959 to study the impact of the State and local tax system on the economy of New York, recently issued an interim Report under date of June 22, 1960. The report contains a series of recommendations with respect to the franchise tax on corporations. Because of the importance of the Study this Department is being devoted to reporting the various recommendations together with explanations provided for therein.

Recommendation No. 1—Revise the formula for allocation of net income by changing the sales factor to a basis of 50 percent "origin" and 50 percent "destination."

In Chapter IV of the Report, entitled "Problems and Issues in the State and Local Tax Structure," the Committee indicates, in discussing the franchise tax under Article 9-A, that special attention was given to the problems relating to the influence of taxation upon the business climate and economic progress of New York. It is reported that in a recent survey more than 75 percent of the companies polled stated that the franchise tax was a factor of major concern to their firms. Furthermore, that foremost among the areas in which change is sought by business, in the interest of improving equity and encouraging the expansion of business within the State, is the allocation formula used to attribute taxable net income to New York State. It is also indicated that more than 90 percent of the companies responding to a questionnaire thought that the allocation formula was unfair.

The Report explains that the New York tax follows the "Massachusetts formula" in that it uses three factors: property, payroll and sales; and that the greatest difficulty has arisen in the definition of the sales factor. In general, under the present rules and regulations, sales attributable to New York State are defined in such a way that the origin of the sale, rather than the destination, controls allocation. Thus, manufacturing corporations, which, according to the study, pay about three-fifths of the Article 9-A tax, stress the point that manufacturing is discriminated against under the original definition of sales. Inasmuch as the property and payroll inevitably weigh heavily against manufacturing companies in New York State, it has been suggested that, to ease the burden, sales be defined in such a way as to stress destination rather than origin. Such action would encourage the loca-

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tion and expansion of manufacturing in this State and would not penalize the storing of goods and the shipment from warehouses within the State's boundaries.

In further support of this recommendation the Report indicates that in recent years several states have modified their corporate income allocation formulas to include a sales-by-destination factor, a shift that has many advocates among businessmen and tax administrators, notwithstanding that many other informed persons still argue for a sales factor based on the origin of sales. Evidently, as a result of this conflict of opinion, the Committee feels that a middle ground appears reasonable at this time. We are advised that the adoption of such a modified sales factor is not intended to result in the taxation of purely interstate commerce but that the change will reduce the tax for a considerable number of corporations, and increase it for others. As a general rule, the tax should be reduced on New York manufacturers selling and shipping goods without New York State, and will be increased for out-of-state manufacturers selling and shipping goods within New York State.

Recommendation No. 2—Make increased use of administrative discretion in adjusting allocation ratios to improve the equity of the tax.

The Report indicates that no single allocation formula will prove satisfactory in every situation and, although the Franchise Tax Law presently provides that the Tax Commission may exercise discretion in adjusting cases of obvious inequity, little use has been made by the Commission of such authority. Therefore, the Tax Commission should develop objective criteria for instances in which the use of discretion would seem justified. The report suggests certain indicators as guides to the use of such discretionary authority, namely:

a. Separate accounting by states,

b. Multiple taxation of income by states, and

c. The proportion of interstate business.

The recommendation further indicates that such factors would be used only to determine the need for adjustments but that the amount of adjustment would be based on a comprehensive study of all of the pertinent information in each individual situation.

Recommendation No. 3—Add provisions for carryover of losses for five years and carryback for three years to conform with Federal Law.

The recommendation is one which taxpayers have endorsed for many years. Your Committee on New York State Taxation has included a similar recommendation in its "Legislative Recommendations" submitted to the State Tax Commission for each of the last several years. The Report of the Tax Structure Study Committee very clearly points out that without permitting corporations to average income over a period of nine years, businesses having alternating years of profits and losses pay more tax than those having the same aggregate net income without losses. Also, many new corporations would benefit since losses in early years could be charged against earnings in future years. It is also stated that under present law, similar provisions are now available to unincorporated enterprises under the personal income and unincorporated business taxes.

Recommendation No. 4—Disallow the deduction of the previous year's franchise tax in computing taxable income.

In making this recommendation, the Committee points out that statutes imposing taxes measured by income usually prohibit deductions of tax pay-

ments made under the same statute, e.g. Federal income taxes are not deductible in computing net income subject to the Federal tax on net income, and that no deduction is allowed for the New York personal income tax in computing that tax or for New York's unincorporated business tax when it is being computed. Furthermore, although the disallowance of this deduction will increase the franchise tax for all firms on an income basis, the combined result of all of the recommended changes in this Report will be to improve the equity of this tax, as well as to provide a stimulus to economic growth in this State.

Recommendation No. 5—Tax real estate corporations under Article 9-A instead of under Section 182 of Article 9.

The Report points out that changes in the tax base under Article 9-A in 1944, and other modifications of that law and its administration, have eliminated any need for special tax treatment of real estate corporations. It also states that as a result of the practice of such corporations reinvesting their earnings in real estate, thus avoiding the two percent tax on distributed dividends, there exists an unwarranted favoritism for this group of corporations. In addition, distinction between such corporations and those under Article 9-A is such a fine one that frequent financial hardship has resulted in a mandatory reclassification from Section 182 to Article 9-A and back again. Because of the technicalities of the fine line of distinction, which is a burden to tax administration as well as to the corporations experiencing the change, over 3,000 real estate corporations were reclassified in 1958 requiring the payment in excess of $750,000 under the two percent tax on undistributed earnings.

The Committee indicates that the present law requires annual valuation of real estate in calculating the tax base, and the Tax Department is neither adequately staffed for reviewing the valuation figures, nor is an annual review administratively feasible. Based on the above reasons, the recommendation is offered with the further suggestion that in the year of reclassification the two percent tax be imposed on net worth, in excess of paid-in capital, which has not been previously subject to tax, using "book value" rather than market value in order to avoid any hardship. Due to a change in privilege years, both the present mill tax and the Article 9-A tax on net income should be waived in the year that the two percent tax on untaxed net worth is assessed. It is the feeling of the Committee that the change would eliminate the confusion and hardship due to reclassification of real estate corporations, and would place these corporations on a basis comparable to other general business corporations.

Recommendation No. 6—Substitute a self-assessed tax for the present tax assessed by the Tax Commission and conform the statute of limitations and the period of limitation for filing refund claims to the Federal requirements.

The effect of the change would reduce the statute of limitations from five to three years other than where 25 percent or more of taxable income has been omitted, in which case it would be extended to six years. The period in which to file claims for refund would be extended from two to three years. Since corporations are required to report any changes in income resulting from a Federal audit, the Corporation Tax Bureau is able to rely on such audit, except in regard to allocation. Therefore, the Committee believes that a reduction in adminis-

trative costs will result upon a change to a self-assessed tax. At present the Corporation Tax Bureau is still required to prepare and mail tax assessments which involves unnecessary work and complicates conformity with Federal regulations. Furthermore, under the present system, the legal obligation for the tax originates when the assessment is prepared by the Corporation Tax Bureau rather than when the report is filed.

Recommendation No. 7—In allocating investment capital eliminate the minimum of 15 percent and in allocating subsidiary capital eliminate both the minimum of 15 percent and the maximum of 50 percent.

The Report points out that the franchise tax law is inconsistent in its use of minimum and maximum limits for allocation formulas. As far as allocating entire net income or investment income, the formula contains neither minimum nor maximum provisions, while the formula for allocating investment capital has a minimum but no maximum, with the formula for allocating subsidiary income being limited by both a minimum and a maximum.

The Report indicates that the study did not develop any convincing necessity or justification for such limitations particularly since, in certain instances, the limits appear to be inequitable. An example is given where one corporation using the formula for allocation of subsidiary capital may have a computed allocation of 5 percent but be taxed on the basis of 15 percent, while another corporation with a computed allocation of 15 percent is also taxed on the basis of 15 percent. The elimination of these limits would not only simplify the administration of the tax but would avoid confusion and controversy in this area.

Recommendation No. 8—Revise the tax rate on subsidiary capital by substituting a flat rate of one-half mill per dollar for the present rate schedule.

The use of a flat rate would be consistent with the flat rate on income and capital so that a few large firms would not receive an unwarranted advantage.

Recommendation No. 9—Permit optional taxation as partnerships for small business corporations, contingent upon election to file under Subchapter "S" of the Federal Internal Revenue Code.

Corporations making such an election under New York State law would become subject to the State unincorporated business tax. Such a change would simplify record keeping and reporting for corporations that make the election under both laws.

UNFINISHED BUSINESS

The Report indicates that because of the time at the disposal of the Tax Structure Study Committee it was not possible to investigate all problem areas in the necessary detail and that the recommendations made were those which appeared to be of the greatest urgency. Some of the further fields of inquiry in which research is planned in the coming year are as follows:

1. Further conformity of the franchise tax on general business corporations to the Federal corporation income tax in such matters as interest paid to stockholders, corporate distributions, reorganizations, liquidations, and so forth.

2. Review of taxation of corporations under Article 9 of the Tax Law and the feasibility of taxing these corporations under Article 9-A. It is assumed that this review will cover corporations subject to tax under Sections 183, 184, etc.

3. Study of the franchise tax on banks and savings and loan associations.

4. Study of the estate tax with a view towards administrative improvement.

5. Continued review of the unincorporated business tax and its application to the various segments of business.

6. Review of the tax treatment of insurance companies.

7. Review of non-resident taxation.

Legislation to implement the various recommendations discussed above is presently in the drafting stage. The Department of Taxation and Finance has requested comments thereon from various groups, including the Committee on New York State Taxation of our Society. The Committee is reviewing the proposed legislation and will submit its recommendations to the Department.

Improvement in Auditing Techniques

The quality of auditing has far-reaching repercussions on the structure of the profession. The aim should be to reduce the detail to the minimum and employ to the maximum the skill of those who have the ability to look for the right things in the right places. They merit remuneration appropriate to their ability and responsibility, but their output is valuable, whereas time spent on needless detailed checking is expensive and wasteful. Improvement in the economics of the profession is the key to improvement in the rewards of those who practice it.

The auditor must first know his objective before he can exercise the care, caution and skill expected of him. There must be many auditors whose early training led them to suppose that the achievement of the same total on both sides of the balance sheet was a significant and satisfying stage in the audit. The profession has moved a long way forward since then, but it still has far to go.

Editorial, "An Audit of Auditors,"

Accountancy, September 1960

Accounting and the SEC

Conducted by Louis H. Rappaport, CPA

SEC CRITICIZES ACCOUNTANTS IN CORNUCOPIA CASE

Some time ago the SEC instituted proceedings to determine whether to suspend or withdraw the listing of Cornucopia Gold Mines on the American Stock Exchange. The SEC had reason to believe that Cornucopia had not complied with the Commission's rules relating to the filing of reports and proxy material. Hearings were held and on August 11, 1960 the SEC ordered Cornucopia's exchange listing and registration to be withdrawn.

The findings and opinion of the Commission are set forth in Release No. 6339 under the Securities Exchange Act of 1934. While the conduct of the accountants in the case was not the primary purpose for the hearing, the SEC, in its decision, makes several statements which are extremely critical of the accountants.

Cornucopia's affairs were in the hands of one Earl Belle who left the United States in July 1958. Belle has been indicted on a number of serious counts, compared to which the SEC proceedings were trivial. At any rate, he did not appear at the SEC hearings.

The SEC names three accountants involved in the Cornucopia case. However, we shall not use the accountants' names but shall refer to them as Mr. A, Mr. B and Mr. C. These are the SEC findings:

IMPROPER STATEMENTS AND REPRESENTATIONS

Mr. A was a partner in a firm of CPAs. An individual who, together with Belle, controlled a company named Eastern, Cornucopia's parent, phoned Mr. A, gave him some figures and information regarding Eastern and asked him to type up a balance sheet for Eastern as of December 31, 1956. Using these figures, Mr. A prepared a balance sheet and transmitted it with a covering letter over the signature of his firm which stated that the accounting firm had "reviewed the books and records" of Eastern and prepared the balance sheet therefrom. Mr. A later stated that he understood this statement to be *pro forma,* although it was not so indicated on the statement or in the covering letter, and also that the statement was merely for the convenience and private use of his client.

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The accountant's statement listed capital in the amount of $802,600, which he obtained by subtracting total liabilities from total assets as given to him by his client. Other evidence in the record indicates that the figures given to Mr. A were false and that the capital figures were grossly overstated. The statement was given to a bank shortly before the time that Eastern procured a loan from the bank to finance its purchase of the Cornucopia stock.

Mr. B, a CPA, at the request of Belle, prepared in draft form a balance sheet of Eastern as of July 31, 1957. Belle obtained from Mr. B his working papers, copies of his firm letterheads signed in blank, and firm binders, with the statement that he, Belle, would arrange to have typed the draft balance sheet and a covering letter by Mr. B, stating that he had prepared the balance sheet from the corporate books without audit. Instead, a different balance sheet and a covering letter stating that an audit had been made were typed on the signed stationery and sent to a bank by Belle in November 1957 and discussed by a bank official with Belle before the bank extended a loan to Cornucopia which was guaranteed by Eastern. The balance sheet so submitted purported to show that total assets of Eastern had increased by $1,406,203 over the December 1956 figures while liabilities increased by only $341,486. From other information in the record it appears that these figures greatly overstated assets and understated liabilities.

In January 1958 Belle asked Mr. B to prepare another statement of Eastern, which Mr. B refused to do. Nevertheless, a second financial statement of Eastern, as of December 31, 1957, under the letterhead and over the signature of Mr. B, presumably prepared on blank signed sheets Mr. B had furnished Belle, was given to a representative of a bank, who discussed it with Belle. This statement showed as of December 31, 1957, assets in the amount of $2,435,958 and liabilities of $387,587, whereas Eastern's books showed assets of only $620,290 and liabilities of $643,253 as of that date.

The SEC decision states that two other false and misleading financial statements of Eastern, one as of January 31, 1958 and the other as of April 30, 1958, were purportedly prepared by C and Company, a name used by a certified public accountant. Although Mr. C signed the auditor's certificates he had not examined or audited Eastern's books and records. He was given draft statements by Belle and was under the impression that Mr. B had prepared the statements after an examination of Eastern's books and records, but Mr. C did not know whether Mr. B had made any audit. The January and April 1958 statements prepared by Mr. C also falsely overstated assets, with the result that large amounts of capital, surplus and retained earnings were shown whereas in fact Eastern had substantial earnings deficits. A copy of the January 1958 statement was sent to a bank.

It is not clear whether any of the statements referred to above, prepared or certified by A, B or C, were filed with the SEC. From a professional point of view, however, this does not reduce the seriousness of the offense.

CORNUCOPIA'S FORM 10-K FOR 1957

As a part of its annual report for 1957 on Form 10-K there were filed financial statements of Cornucopia certified by C and Company. The letterhead on the certificate carried the additional statement "Certified Public Accountants" and at the bottom was a notation "Members: New York State Society of Certified Public Account-

ants — American Institute of Certified Public Accountants." The firm consisted solely of Mr. C; he had no associates or employees. He had been employed as an accountant and bookkeeper by subsidiaries of Cornucopia and had been a director of a subsidiary.

The SEC ruled that Mr. C's certificate was false and misleading in several respects. In view of his connections with subsidiaries, he was not in fact an independent public accountant in relation to Cornucopia. Since he had no associates or employees, it was misleading to use the words "and Company," "Certified Public Accountants" and "Members" on his certificate.[1] In addition, the recital of membership in the American Institute of Certified Public Accountants was untrue since he had not yet been admitted to such membership when the statements were certified in May 1958. Moreover, the certificate falsely stated that Mr. C had examined the financial accounts and records of Cornucopia and that such examination was made in accordance with generally accepted auditing standards and accordingly included such tests of the accounting records and such other auditing procedures as were considered necessary under the circumstances. Mr. C had made no audit of, nor had he even seen Cornucopia's books and records, and the statements he certified were copied, with some figure and wording changes, from statements prepared by Mr. B.

The financial statements themselves were false and misleading in a number of respects, according to the SEC. For example, Eastern had on January 20, 1958, issued a check to Cornucopia for $125,000 out of the proceeds of a loan Eastern had obtained that same day from a bank. Cornucopia's cash receipt book, however, was made to show the $125,000 as received on December 31, 1957. The figure for cash on the Cornucopia statement of assets reflects the pre-dating of the receipt of this $125,000, and such pre-dating also made the notes payable item on Cornucopia's statement of liabilities incorrect.

PROXY SOLICITING MATERIAL

The preliminary copies of proxy soliciting material filed with the SEC by Cornucopia with respect to a proposed stockholders' meeting in July 1958 included a proposal that the firm of C and Company be elected as independent auditors for Cornucopia, and with the statement there were filed financial statements for Cornucopia and subsidiaries certified by C and Company. The proxy statement and the certificates were false and misleading in representing that C and Company was a "firm" and that it was independent, in view of the facts, previously noted, that Mr. C had no associates or employees of any kind and had been employed by subsidiaries of Cornucopia.

SEC also held that the financial statements included in the proxy soliciting material were false in many respects. The accountant's certificates were also false in stating that the financial statements were based on audits of the books and records of the companies, since, as previously noted, Mr. C had made no audits of the books and records of the companies.

[1] According to the SEC's decision, use of the words "and Company" by a certified public accountant practicing alone is prohibited under New York law. 16 N. Y. Consol. Laws Ann. (McKinney), #7407, as construed by Op. Counsel N. Y. Educ. Dept. No. 52 (1952).

Although Mr. C stated that he certified statements which he understood were prepared by Mr. B, there were a number of differences between the two sets. Some of the changes are discussed below.

Mr. C's statements showed higher cash figures for four subsidiaries. (These changes in cash figures were from $10,549 to $20,549 for Century, from $196.90 to $5,196.90 for Aero-Cal, from $1,294.05 to $16,294.05 for Schutter Corp., and from $18,612.67 to $36,612.67 for Troop.) In most instances, the corresponding increase in credit balances occurred in the item of long-term indebtedness. Assets of one subsidiary were written up by $43,000 and of another subsidiary by $40,077.60. The previous accountant's statements had said that certain assets were carried at figures determined by appraisals made by the respective boards of directors of those companies, whereas Mr. C's statements stated that the figures were based on appraisals made by independent appraisers.

Contingent liabilities on notes aggregating $36,100 in the case of Century and $22,500 in the case of Aero-Cal shown on the previous accountant's statements are not referred to in Mr. C's statements. There were also other material misstatements and omissions in Mr. C's statements, according to the SEC.

As previously noted, the SEC ordered the registration and listing of Cornucopia's common stock to be withdrawn. We do not know whether any proceedings have been instituted by the SEC against any of the accountants involved in the case.

Income Leakage

Maintaining a meticulous daily record of the time spent and the nature of the services performed for each client is a tedious proposition. Yet, since the invisibles of time and skill constitute the accountant's stock in trade, it can be stated categorically that neglect or carelessness at this point can be more costly to practitioners than leakage at any other point in the economic cycle. Stated positively, the time spent in painstaking recording of each day's service will consistently yield more monetary return per minute than any other time spent in the office. The unhappy fact is that without a detailed day-to-day record the elusive and perishable product is, as if by evaporation, literally lost for billing purposes. Here, then, if any place, is where good suggestions might go a long way toward stopping preventable leakage, and where the subject should be presented in such a manner that the small practitioner can visualize it and apply it to his own practice.

THE CHARTERED ACCOUNTANT,
India, June 1960

Administration of A CPA Practice

Conducted by MAX BLOCK, CPA

RETAINER FEES — A FOREIGN CONCEPT

Chapter 12 of the CPA Handbook (AICPA) deals with the subject of fees. It contains much worthwhile material gathered by an outstanding accountant, T. Dwight Williams, CPA.

In the discussion of retainer contracts there is this interesting observation—"In the United States, a retainer fee paid to accountants usually means a fee paid for all services of whatever nature or for services of a specific nature rendered during a designated period. This definition differs from the English concept in requiring that services are to be performed for the fee. In England the fee is paid so that the accountant will be available if needed whether or not services are performed."

Perhaps there are some English oriented firms in this country that follow this practice. Otherwise it is probably very rarely that an American firm gets a stand-by fee. Yet there is as much logic for such an arrangement as for the "capacity" charge made by public utilities, or the stand-by charge made by banks for undrawn loan commitments. Where accountants maintain an organization, continuously throughout the year, in order to be able to supply a special service to a client when, as, and if called on, some recovery should be made of the stand-by overhead.

Custom, of course, dies hard and anyone proposing to adopt the English system will have a "hard sell" job on his hands. Yet, if an accounting firm is suffering too large a loss on unassigned time, is this not a justification for consideration of a stand-by fee? This aspect has not been discussed, so far as known, in recent considerations of fee arrangements. It is deserving of some attention.

PROFESSIONAL "ASSOCIATIONS" FOR CORPORATE TAX BENEFITS

Accountants who are interested in this subject, for their own benefit or for clients, will find an authoritative and lucid exposition of the mechanics for successful organization in the Prentice-Hall Tax Ideas Service, page 9281. It is in the form of an article by Richard L. Mackay, a Dallas attorney, which is entitled "How to Set Up a Professional 'Tax Corporation'." It is divided into six sections, namely:

1. Why use an association as a form of business organization?

2. How is an association taxable

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as a corporation identified?

3. Non-tax consequences of use of an association.

4. What tax advantages does the association have over the partnership?

5. How to establish the association—articles and by-laws.

6. Conclusion.

Section 5 is particularly significant because therein is reproduced the articles of association (charter) and the by-laws of a medical association that successfully passed tax scrutiny. Moreover, the author intersperses helpful comments and explanations amongst the provisions.

SPIRAL BINDS FOR ACCOUNTANTS' REPORTS

Accountants should investigate the significant improvement in reading convenience made possible by the spiral binding of reports. Reports lay absolutely flat, regardless of what part is referred to, if spiral bound. Binding margins disappear as a typing problem. One is spared from trying to read material that is on a curved surface or that is partly concealed because of an inadequate margin. The spiral binding appears to be as tamper proof as an ordinary staple binding, and it is easy to attach.

The only disadvantage observed, a minor one, is that the binding is slightly thicker than the report. This means that some extra filing space will be used for office copies of typed reports if they are spiral bound than if staple bound.

CHANGE IN EDITORSHIP

Ten years ago I was called on to initiate and conduct this column. Now a new opportunity beckons for even greater service to the magazine, the Society, and the CPA profession. To become the Managing Editor of the magazine was an irresistible call, and your Editor is winding up his ten years of service in this Department with this issue to move on to the new post.

My experience has been very rewarding, personally. It has been the means of enlarging my own knowledge of an area of human relations that vitally affects relationships in every other area of life. It has brought to me many professional friends, which, in itself, is an adequate reward. It has enabled me to utilize and express my literary and educational urges, making for a sounder emotional life and for many gratifications. The greatest gratification that I experienced came from the feeling that I was helpful to others.

I am thankful to all who have contributed to the Department, directly and indirectly, and approach my new task with the confidence engendered by the many associations and experiences that developed over the past ten years. I will continue my public accounting practice, on a reduced time basis, thereby retaining my direct contact with the practical aspects of the profession.

Arrangements have been made for the continuance of the Department and readers may look forward to a new and fresh touch in future issues. Herbert G. Whiting, CPA, Chairman of the Committee on Administration of a CPA Practice of our Society will act as Editor, assisted by his Committee, during the term of his committee chairmanship.

MAX BLOCK

Payroll Tax Notes

Conducted by SAMUEL S. RESS, CPA

PROPOSED CHANGES IN NEW YORK UNEMPLOYMENT INSURANCE LAW

The following recommendations will be submitted to a sub-committee of the Society's Committee on New York State Taxation which is compiling suggested revisions in the law for submission to the Advisory Council of the New York State Unemployment Insurance Department.

Encouraging Voluntary Payments

The law permits an employer to make voluntary payments in addition to the regular taxes required if he wishes to improve his "employer's account" balance. Such payments are not subject to refund or credit, nor can they be made while an employer is delinquent in his obligations under the Law.

Up to the present time very few, if any, employers have been able to take advantage of this tax rate reduction provision, contained in section 581.1 (d) of the Law. The proposed changes would serve to eliminate the obstacles to voluntary payments.

Section 581.1 (d) reads as follows:

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". . . Any employer may at any time make payments to his account in the fund in excess of the requirements of this article. Such payments shall be credited to the employer's account as of the June 30th coinciding with or next following the date of payments. Such excess contributions shall be irrevocable and not subject to refund or credit after acceptance by the commissioner and deposit in the fund. . . ."

The "employer's account percentage" is based on the status of the "employer's account" as of the "computation date" which is July 1st following the above mentioned June 30th. The employer does not have sufficient information by June 30th to determine whether or not a voluntary contribution would be advisable because the Division of Employment does not provide the Notice of Experience Rating Charges to the "employer's account" for the last weeks prior to the July 1st computation date until at least two or three weeks after that date.

Two proposed changes in the statute are suggested. First, it would be more equitable to provide that where an employer pays excess contributions prior to the July 1st computation date, for the purpose of securing a more favorable employer account balance and a lower tax rate, and that if the lower rate does not materialize because of adverse experience, then the voluntary contribution heretofore made should be applied against the employ-

er's liability for unemployment contributions on taxable wages paid after the computation date. If the employer has no further liability for unemployment contributions which would absorb the excess contribution payment, it should be refunded to the employer upon his application for refund.

Secondly, it is proposed that the employer should be given a fair and reasonable opportunity to make a voluntary contribution, so as to secure a lower contribution rate, by providing that he may make such voluntary payment within thirty days after he receives his last Notice of Experience Rating Charges with respect to the year immediately preceding the computation date. If this amendment is enacted the employer who actually maintains a regular experience rating control system and accounts, reflecting benefit charges and "employer's account" credits, may be enabled to take advantage of this tax rate reduction provision.

Eliminating Double Benefits

It is generally understood that the Unemployment Insurance Law was enacted to provide some income during limited unemployment, as a relief measure, where the unemployment is due to conditions in the economy and the labor market and through no fault of the worker. However, there are double benefits in certain instances where persons who have received vacation pay are nevertheless paid unemployment insurance benefits in addition. This condition, the elimination of which is now proposed, arises under the present law where vacation pay is not paid directly by the employer to the recipient, but is paid to a union vacation fund or to a fund governed by employer and employee representatives, which in turn pays the vacation pay to the employee.

At the present time, Section 591.3 of the Unemployment Insurance Law provides:

". . . A 'vacation period' during which no benefits shall be payable to a claimant is a period (1) during which a claimant has a temporary respite from work; and (2) for which entire period such claimant is given a vacation payment or allowance by his employer *directly*, . . .";

". . . Any unemployment suffered by a claimant under any of the circumstances set forth in subparagraphs (2), . . . for which unemployment the claimant is not given a payment or allowance by his employer *directly*, shall be considered unemployment for which benefits are payable, provided the claimant is otherwise eligible for benefits."

It is proposed that Section 591.3 of the Law be amended so as to provide that where an allowance for vacation pay is provided out of a union vacation fund or other vacation fund arrangement to which the employer makes vacation contributions on behalf of a group of his employees, that these payments be deemed direct payments under the Law so as to make the recipients of vacation pay or allowances from a vacation fund ineligible for unemployment benefits during a paid vacation period.

N. Y. UNEMPLOYMENT TAX RATES IN 1959 AND 1960

Unemployment insurance tax rates for New York employers average 2.30 percent of *taxable* payroll for this year. In 1959 the average rate was 2.02 percent of *taxable* payrolls, which represent only the first $3,000 an employer pays to each employee during a calendar year. The average rates, when measured by employers' *total* payrolls, both taxable and ex-

empt, were 1.38 percent in 1960 and 1.19 percent in 1959. The over-all increase in tax rates for individual firms was caused primarily by the record amount of benefit payments disbursed by the Division of Employment between mid-1957 and mid-1959.

Depending on their individual experience with unemployment, rates for individual firms ranged from 0.9 to 3.2 percent in 1960. In 1959, the rates ranged from 0.7 to 3.0 percent. 5,871 firms received the minimum rate of 0.9 percent for 1960 while 6,215 firms received the 1959 minimum rate of 0.7 percent.

Employers who were late filing reports were assigned 3.0 percent rates regardless of otherwise favorable experience. Other firms whose tax payments did not cover benefit withdrawals charged to their individual employer accounts were charged either 3.0 percent or 3.2 percent rates depending upon whether they had had negative account balances for only one year or for two or more years successively. In 1960, 65,000 employers showed negative account balances, some 15,000 more than in 1959.

UNEMPLOYMENT INSURANCE BENEFIT RULES LIBERALIZED FOR NEW YORK AND NEW JERSEY EMPLOYMENT

Effective September 1st, 1960, unemployment insurance eligibility rules have been liberalized for persons with recent employment in New York and New Jersey. The change was made possible when New Jersey became a signatory to a multi-state agreement to which New York is a party along with all the other states except Mississippi, Kentucky and Alaska. The agreement permits a worker to combine his New York and New Jersey wage credits, if he has not had sufficient work and earnings in either state, to qualify for benefits under either State's law. His right to unemployment insurance and the amount of his benefits will be determined under the law of the State where he files his claim. Persons who had heretofore been deemed ineligible for benefits under the New York statute because of not having earned wages in New York during each of 20 weeks out of the 52 weeks preceding the filing of an initial benefit claim, or in the alternative of not having had 15 weeks New York employment out of the preceding 52 weeks and 40 weeks of New York employment out of the preceding 104 weeks, may refile for New York State benefits if they have had New Jersey employment which, combined with the New York employment, would now make them eligible claimants.

RECENT UNEMPLOYMENT INSURANCE DECISIONS

Compulsory Retirement

In Appeal Board Case Number 71,117-59, it was held that a union contract requiring compulsory retirement at a specified age does not represent a withdrawal from the labor market of workers retired under the contract. Such retirement of itself does not render them ineligible for benefits if they are ready, able and willing to work.

Leaving Job To Attend College

A day student who quit his night job to attend evening college classes in order to obtain a full time job, leaves his employment without cause according to the decision handed down by the Appeal Board in Case Number UCX-20-60.

Leaving Employment On Day of Termination Prior To Quitting Time

A claimant who deliberately foregoes the opportunity of earning addi-

tional wages during the balance of his last day of employment to keep within the statutory limitation for partial unemployment benefits places himself without the scope of the provisions authorizing the payment of partial benefits and thus renders himself ineligible for benefits in that week. (See Appeal Board Case Number 73,779-60).

College Student's Restriction To Part-Time Employment

A claimant with a prior history of full-time employment who restricts himself to part-time employment because of college attendance is unavailable for employment within the meaning of the law and is not entitled to benefits during such period of time. (Appeal Board No. 74,013-60).

Federal Taxation

Decisions and Rulings—RICHARD S. HELSTEIN, CPA

Commentary —Committee on Federal Taxation
Chairman, ARTHUR J. DIXON, CPA

DECISIONS AND RULINGS

DISPOSITION OF TAX COURT CASES

A new procedure for the disposition of cases docketed before the Tax Court has been announced. All docketed cases in which the deficiency notices were not issued by Appellate Division and which do not involve recommendations for criminal prosecution, will be referred to Appellate Division by Regional Counsel as soon as they are docketed in the Tax Court. (Cases in which the deficiency notices were issued by Appellate will be retained by Division Counsel for preparation for trial.) As soon as the file has been received, Appellate will arrange a conference for purposes of settlement. In past practice such conferences either were initiated by the taxpayer or did not arise until the case was calendared for trial and stipulations were being prepared. The conference will be attended both by a member of Appellate Division and Government Counsel.

As in the past, if a settlement is agreed upon, the computation, write-up and stipulation will be prepared, and the stipulation will be filed with the Tax Court. If a settlement is not effected, the file will be returned to Counsel for preparation for trial. In the event of a disagreement upon the settlement between Appellate and Government Counsel, the case will be referred to Chief Counsel for decision. (See NYCPA June 1958 p. 449 re: "Settlement of Cases.")

During the period between receipt of the Tax Court's "Trial Status Request" (usually issued from 60-90 days in advance of the issuance of the trial calendar) and the receipt of the trial calendar (usually issued about 90 days in advance of the date of the calendar) Appellate will conclude settlement negotiations on all cases not previously settled or referred to Counsel for preparation for trial.

Where settlement is not effected and the file has been returned to Counsel, the taxpayer will be advised by letter from Appellate. Furthermore, upon receipt of the trial calendar setting the case, Regional Counsel will send to the taxpayer an "appropriate letter" which will suggest a conference for the purpose of stipulation of facts.

Any requests by the taxpayer for conferences after receipt of the trial calendar will be referred to Regional Counsel.

These procedures shall become effective with respect to all trial calendars issued by the Tax Court on and after November 1, 1960 (T. I. R. 249, 8/30/60 to appear in IRB 1960-37 as Rev. Proc. 60-18).

STRAWS IN THE WIND

There have been recurrent warnings that the Internal Revenue Service plans to take all steps possible to end the abuses in computing taxable income which have become more and more flagrant since World War II. Not only have procedures been installed to enable examining agents to detect the use of the "expense account" for "fringe benefits," but there have been indications that in extreme cases fraud penalties will be asserted and even criminal prosecution invoked. See, for example: *Frank Fehr Brewing Co.* (DC Ky.—1958, 160 Fed. Supp. 631) *U.S.* v. *Keenan* (CA-7, 1959, 267 Fed(2d) 118, reported in NYCPA August 1959) and *U.S.* v. *Brill* (CA-3, 1959, 270 Fed(2d) 525 reported in NYCPA January 1960) all involving misuse of expense accounts. And in *Janko* v. *U. S.* (CA-8, 1960) the Circuit Court of Appeals affirmed the conviction and jail sentence of a taxpayer for "falsely" claiming his children as dependents.

Thus, it is apparent that the government will no longer countenance the laxity with which many items have been treated in the past. Prosecutions for fraud are no longer limited to willful omission of income, but now may be commenced for willful overstatement of deductions as well.

Furthermore, the Treasury has embarked upon a program to enforce the reporting of interest and dividends. It is checking forms 1099 against tax returns and is also checking payers of dividends and interest to see that forms 1099 are filed.

In fact, the Justice Department has a separate unit handling the prosecutions in the dividends and interest area, and there have been 31 prosecutions since the program began.

It is imperative that we, as accountants, are not only meticulous in the preparation of tax returns, but that we impress our clients with the importance of filing the required information returns. It is also advisable to acquaint clients with the Treasury's expanded program.

CONTRIBUTION OF APPRECIATED ASSETS MAY ENTAIL TAXABLE GAIN

In two recent cases, where taxpayers have made contributions of appreciated assets, the Courts have found a "realization of gain" resulting in capital gains tax upon the increase in value.

While the cases are completely dissimilar, they are both worthy of note.

In the first case, the warning is clear that a donation must be bona fide and that the deduction for contributions is not to be used as a vehicle for tax avoidance.

A corporate taxpayer owned 1,000 shares of stock with a cost basis of $10,444, for which it had received an offer of $42,500. The corporation had authorized a donation of up to $1,000 to a university, and its president had pledged $500 on the taxpayer's behalf. The corporation then borrowed $42,000 from a bank and pledged the appreciated stock as col-

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lateral, and donated its equity in the stock to the university, subject to the bank loan. The University accepted the donation, paid off the loan and sold the stock for $42,500 (less $16 transfer tax). The taxpayer claimed a deduction of $500 as a donation and reported, through Schedule M, the difference between its cost and the market value as non-taxable income.

The Commissioner claimed the difference between cost and $42,000 was taxable as long-term capital gain and that the donation was limited to $484. The Tax Court upheld the Commissioner. It pointed out that the loan was a sham in that there was no intention to repay it, that it had no business purpose beyond that of tax avoidance. The Court looked to "the economic realities of the disposition [which] were in substance a sale of the stock for a price of $500 less than its fair market value of $42,500, thus making the selling price $42,000 with a gift of the balance after transfer taxes." (*Magnolia Development Corp.* TC Memo 1960-177)

In the other case, a contribution of appreciated real estate was made to an exempt employee's retirement trust. The contribution was *not* in settlement of a legal obligation (cf *Int'l. Freighting Corp., Inc.* v. *Com.* CA-2, 1943, 135 F(2d) 310). The Commissioner attempted to tax as capital gain the difference between the basis of the property donated and its value at the time of the donations. The corporate taxpayer argued that there could be no gain because nothing "was realized". The Court of Appeals ruled that realization is not confined to tangible benefits. It stated that there was a gain to the extent of the market value used as a deduction on the corporation's tax return. Accordingly, the taxpayer was taxed at capital gains rates on the difference between its basis and the market value of the property donated. (*U. S. A.* v. *General Shoe Corporation* CA-6, 9/2/60).

TREATMENT OF INTEREST RECEIVED ON BONDS PURCHASED "FLAT"

The Commissioner has revoked Rev. Rul. 55-433 (1955-2 CB 515) which held that where bonds were purchased "flat", and the interest which had been in default and which had accrued prior to the purchase, was repaid, and where there was a possibility of the principal being repaid, such interest was ordinary income when received.

This position was declared invalid in *Estate of Hamilton Rickaby* (27 TC 886), to which decision the Commissioner has announced his acquiescence in IRB 1960-35, 7.

Accordingly, in Rev. Rul. 60-284 (ibid. at page 28) the Commissioner has held that the receipt of defaulted interest accrued prior to the "flat" purchase is to be treated as amounts received upon the retirement of the bonds and thus as amounts received in exchange therefore for purposes of capital gain treatment.

Interest accruing after the purchase of such bonds represents interest taxable as ordinary income.

COMMENTARY

AVAILABILITY OF INSTALLMENT METHOD ON SALE OF A BUSINESS

In this department, August 1960 issue, it was pointed out that a taxpayer making use of a Section 337 corporate liquidation is deprived of the opportunity to use the installment method for reporting his profit. Ap-

proaches using other Code sections may, however, be available.

Section 333, the so-called one-month liquidation section, permits the shareholders to liquidate the corporation and to take over the property at a tax basis equivalent to the basis of their shares of stock, subject to various adjustments enumerated in the statute. Consequently, any tax liability is deferred from the date of liquidation to the date of sale of the property. Furthermore, the former stockholders may use the installment method to report their gain on such sale. However, use of this section is not usually advisable where the corporation has a substantial surplus, as such surplus is taxed to the stockholders as an ordinary dividend at the time of liquidation of the corporation. Also, care should be taken to avoid a contention by the Internal Revenue Service that the corporation and not the stockholders made the sale. (*Court Holding Co.*, 324 U. S. 331, 1945.)

Consideration should also be given to the sale of the stock of the corporation, which will permit the selling stockholders to use the installment method. A corporate purchaser of the stock may have no objection to this method because liquidation of the acquired shares under Section 334 (b) (2) will give the acquiring corporation a stepped-up basis for the assets acquired through the stock purchase. An individual purchaser can obtain the same result in a normal liquidation, taxable under Section 331.

NON-RECOGNITION OF GAIN UPON SALE OF JOINTLY OWNED RESIDENCE

Under Section 1034 of the Internal Revenue Code a taxpayer who sells his principal residence and acquires a new residence within a given period is permitted to defer recognition of the gain on the sale of the old residence to the extent that the sales price (with adjustments) is reinvested in a new residence. An interesting problem may arise when the residence is owned jointly by husband and wife. Suppose the couple obtains a divorce and the property settlement provides for sharing the proceeds from the sale of the residence. Prior to the time of the divorce both husband and wife used the home as their principal residence. Can they defer recognition of their respective shares of the gain if within the prescribed time limits they each acquire a new personal residence?

It is understood that in private rulings the Service has taken the position that separate acquisitions of new residences by divorced persons will qualify under Section 1034. The test as to difference between sales price and cost of new residence is applied separately to each person. However, if the couple had been separated for several years prior to the divorce, in all likelihood deferral of gain will be permitted only to the spouse who had actually lived in the home prior to the sale of the residence. The denial of nonrec-

ognition to the other spouse would be based on the premise that the residence sold was not his principal residence.

Suppose two individuals sell their homes, marry, and apply the proceeds from the sales of their respective homes to the price of a new residence. Under these circumstances the tests of Section 1034 would be applied separately to the husband and wife. Each would be considered to have acquired the appropriate fractional share of a new residence and gain would be recognized to each spouse only to the extent that the sales price (with appropriate adjustments) of each spouse's former residence exceeded the cost of the share of the new house acquired.

DISAPPEARING AND REAPPEARING BASIS OF PROPERTY ACQUIRED BY GIFT

The field of federal taxation is not exempt from dangers inherent in oversimplification. One area of danger exists in the determination of the basis of property acquired by gift.

Taxpayers are prone to think, in the case of property acquired by gift after 1920, that the basis for determining a gain is the donor's basis and that the basis for determining a loss is the lower of the donor's basis or the fair market value of the property at the time of the gift. In most cases this shorthand method of expressing the rule reaches the correct result.

However, Section 1015 of the 1954 Code (and corresponding sections of prior laws) states quite clearly that the basis for gain "shall be the same as it would be in the hands of the donor *or the last preceding owner by whom it was not acquired by gift.*" (Italics supplied). This section has most interesting current applications when combined with the pre-1921 rule that the basis (for determining either gain or loss) is the fair market value at the time of the gift.

Suppose that in 1916 A purchased stock of X Corp. for $35 per share. In 1919 A made a gift of this stock to B at a time when its fair market value was $128 per share. In 1921 B made a gift of the stock to C, who shortly thereafter sold it for $86 per share. C has taxable gain of $51 per share, since he must refer back to A's cost in determining his basis for gain. These were essentially the facts and the decisions in *Aaron Mendelson*, 18 BTA 215 (1929) and in *Wurlitzer* v. *Helvering*, 81 F. (2d) 928 (6th Cir., 1936), affirming 29 BTA 658. It is interesting to note that if, instead of giving the X Corp. stock to C, B had sold it for $86 per share, B would have realized a loss of $42 per share since his basis was the fair market value at the time he acquired the stock by gift in 1919.

Situations potentially similar to the *Mendelson* and *Wurlitzer* cases are particularly apt to appear where persons, now elderly, who received gifts of stock or other property prior to 1921 are contemplating passing down such property by gift to younger generations. It is desirable to analyze these gifts from an income tax viewpoint (as well as from an estate planning viewpoint), especially if there is any likelihood of a future taxable transaction, when the basis of the property will become important.

The courts, in effect, have construed the above-quoted portion of Section 1015 as if it read "shall be the same as it would be in the hands of the last preceding owner by whom it was not acquired by gift," thereby making the words "the donor or" superfluous. See *Wilson Brothers & Co.*, 124 F. (2d) 606, 610 (9th Cir., 1941).

Under this interpretation, Section 1015 can permit basis to reappear.

Suppose that in 1914 D purchased stock of Y Corp. for $100 per share. D made a gift of this stock to E in 1919 at a time when its fair market value was $40 per share. The present fair market value is $110 per share. If E now sells these shares he will realize a gain of $70 per share. But if E makes a gift of his Y Corp. shares to F who then proceeds to sell, F's basis will be determined by reference to D, and F will have a realized gain of only $10 per share. Probabilities are that situations like this exist with respect to a number of taxpayers—waiting to be discovered.

WILL REMARRIAGE TO NONRESIDENT ALIEN PRECLUDE SURVIVING SPOUSE STATUS?

Certain widows and widowers are permitted by Section 2 of the Internal Revenue Code to obtain the benefits of income splitting for the first two tax years after the year in which the death of the spouse occurred. The allowance of this privilege is conditioned, among other things, on the requirement that such "surviving spouse" must show that he could have filed a joint return in the taxable year in which his spouse died. The fact that he did not choose to file a joint return is immaterial. It would also appear that if a surviving spouse was prevented from filing a joint return because of the refusal of the executor or administrator of the deceased to execute such a joint return, he would not thereby be precluded from enjoying the benefits of splitting income in the succeeding two taxable years.

Another requisite for the "surviving spouse" is that he may not remarry at any time during the taxable year. Would remarriage to a nonresident alien be an exception to this rule?

Although Section 6013 provides that a joint return may not be filed by the husband and wife where either is a nonresident alien at any time during the taxable year, it does not provide, as some may assume, that the resident spouse is to be treated as "unmarried" for tax purposes. It is only in defining "head of household" in Section 1 (b) of the Code that the law specifies that a taxpayer shall be considered as not married at the close of his taxable year if at any time during the taxable year his spouse is a nonresident alien. Since the bar to "surviving spouse" status speaks merely of remarriage, it would thus appear that the widower taxpayer's marriage to a nonresident alien with whom a joint return is barred, would prevent him from enjoying the income splitting benefits through his deceased spouse.

LOANS TO EMPLOYEES SECURED BY INTEREST IN EMPLOYEE BENEFIT PLANS

What happens taxwise if an employee obtains a loan from his employer and puts up his interest in a pension or profit-sharing plan as collateral? Can this result in unforeseen taxes to the employee and possibly in disqualification of the plan as tax-exempt?

The answer seems to be that under ordinary circumstances there will be no such unfortunate results. Revenue Ruling 56-432 is reassuring in a situation of this type. Where a plan contains a spend-thrift clause which prohibits assignment of an employee's interest but makes an exception for the employer who can accept such assignment as collateral for a loan, the ruling says that no prohibited diversion for the benefit of the employer occurs. It can be inferred from this that the receipt of a loan by the employee from the employer does not result in taxable in-

come, at least if the loan is repayable within a reasonable period of time.

Although occasional loans of this type may be safe enough, the picture changes if loans become so frequent and extended in time that they defeat the purpose of a plan of deferred compensation. Let us assume an extreme case of a profit-sharing plan where contributions are made within the permissible limit of 15% of nondeferred compensation to covered employees. The employer makes it a practice to make loans to these employees in amounts equal to such contributions, repayable upon separation or retirement of each employee with interest equal to the expected earnings of the plan. Upon his retirement the employee in effect receives nothing and pays nothing since his entire interest in the plan is turned over to the employer as repayment of the loan and interest.

If this were to be treated as a qualified plan, the employees would in effect receive all their compensation currently but the 15% called a loan would not be taxable until they retire. It takes no great imagination to foresee that the Internal Revenue Service would frown upon the whole idea, disqualify the plan and tax the employees on the entire amount received by them.

A word of caution is therefore in order whenever loans to employees are tied in any way to employee benefit plans. If such loan is made and it is essential to secure it by an assignment of an interest in a plan, it should be a loan in reality as well as in form, and not an advance payment of compensation.

DEDUCTIBILITY OF EMPLOYEES' MOVING EXPENSES

The recent double about face by the Internal Revenue Service concerning

the deductibility of employment agency fees paid by employees, calls attention to the policy concerning employees' moving expenses.

The Commissioner continues to distinguish between moving expenses of old employees and of new employees. The policy concerning *old* employees is covered by Revenue Ruling 54-429. When transfers of employees from one place of duty to another permanent place of duty are made in the interest of the employer, all expenses paid by the employer for moving the employee, his immediate family, household goods and personal effects are tax-free to the employee. If the old employee pays for these expenses himself and the employer reimburses him, such reimbursement is not taxable to the employee. If, however, the old employee actually is obliged to spend more for moving than the employer pays for or reimburses, the excess is not deductible. Conversely, if the employee fails to spend the entire amount of the moving allowance given him by his employer, the excess is fully taxable as additional compensation.

Despite the Commissioner's agreement to allow the deduction of employment agency fees in seeking new employment, he continues to deny the deduction of moving expenses to *new* employees. Revenue Ruling 59-236 specifically holds that expenses incurred by an employee in moving his family and household goods from one locality to another where he had accepted a new employment with another employer represent nondeductible personal, living or family expense. Further, any allowance or reimbursements received from the employer must be included in gross income.

Classified Section

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